THE

Investment Merits of American Municipal Bonds

HALSEY, STUART & CO. INC.

CHICAGO, 201 *South La Salle Street* • NEW YORK, 35 *Wall Street*

AND OTHER PRINCIPAL CITIES

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Introduction

THE *subject matter of the present book appeared originally in 1934-1935 in a series of ten brochures. So widespread and continuing has been the demand for the brochures, individually and as a series, that revision and consolidation into a single book was finally decided upon. A contributing factor to this decision was the ever widening interest in municipal bonds, resulting from their excellent record throughout the distress period, and the relative scarcity of readily available literature comparable in completeness and detail with the present book.*

For institutional buyers and experienced individual investors in municipal bonds, the book will have value as a compact review and reference source. For investors less experienced in what to look for in municipal bonds, it will prove invaluable as a guide. For municipal officers charged with the responsibility of maintaining strong credit standing for their communities, the book will serve a useful purpose.

As dealers in selected municipal bonds over a long period, our organization offers its further services in whatever way they may prove most helpful to those interested in the type of obligation dealt with in this book.

HALSEY, STUART & CO. INC.

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The Investment Merits of American Municipal Bonds

General Considerations

AMERICAN municipal bonds, as a class, have traditionally occupied a place of distinction in the financial markets—a position in respect to security second only to the direct or guaranteed obligations of the United States Government. They have long been preferred by investors seeking conservatism above all other features. Their record under the widely varied conditions of many decades has amply supported this reputation.

It should perhaps be explained in the beginning that the term *municipal bonds* (or "municipals") is, to some extent, a misnomer. Logically, it would appear to designate only the bonds of cities, towns, and villages—municipalities in the literal sense of the word. As a matter of common practice, however, municipal bonds are spoken of as including also the obligations of counties, special tax districts organized for school, park, sanitary, and other purposes,

and even the bonds of the several states. Unless the contrary is indicated, the term will ordinarily be used in this broadly inclusive sense throughout this booklet.

Types of Municipal Issues

FROM the standpoint of the provisions made for their payment, municipal obligations may be divided into these principal classes:

- Direct and General Obligations
- Revenue Bonds
- Special Assessment Bonds
- Tax Anticipation Warrants

Direct and General Obligations may be described as municipal bonds for which the full faith and credit of the issuing civil division are pledged, and for the payment of principal and interest on which all taxable property within such division is subject to levy of taxes.

Revenue Bonds are a type of municipal differing in various respects from the foregoing. The term, as commonly understood, refers to obligations issued by municipalities and even states for the purpose of financing electric plants, water works, or similar properties to be operated as public enterprises. In issuing such bonds, a municipality ordinarily covenants to pay principal and interest solely from the earnings of the property for which the loan is made; also to establish and collect rates for service which will at all times suffice for the service on the bonds and for operation and maintenance of the system. In some states, moreover, the issuance of revenue bonds provides for the mortgaging of the property for which the loan is made. State highway obligations represent a comparatively new form of revenue obligation that is becoming increasingly important.

Special Assessment Bonds are not payable from a general tax levy, but only out of assessments levied upon property benefited by improvements for which the bonds are issued. The full faith and credit of the general community in which the improvement is made are *not* pledged. In certain cases, however, special assessment bonds are payable primarily from special taxes, with the city assuming any deficit in such taxes. Where this is true, the bonds are properly classified as "generals." Where there is no such pro-

vision, it is important that the holder of special assessment bonds inform himself carefully regarding the character and value of the property upon which the special assessments are to be levied, and that he keep a close check upon tax collections. Considering both their legal status and their record, and the fact that the secondary market for them is generally limited, special assessment bonds may ordinarily be said to occupy a position distinctly inferior to that of general obligations, and the two types should under no circumstances be confused by the investor.

Tax Anticipation Warrants are another important class of municipal obligations. They are usually issued for relatively short periods to meet the financial needs of communities until taxes are collected. They ordinarily represent a first claim upon tax revenues, and are restricted to a lesser amount than the total of the anticipated payments. The investment quality of such warrants depends directly upon the credit of the issuing municipality and its status with reference to tax collections. They are frequently without fixed maturity—payment depending upon tax receipts.

The Demand for Municipals

THE demand for municipal bonds arises from these major sources: from institutions, such as insurance companies, fraternal organizations, and foundations; from banks and corporations; and from estates and individual investors. Certain differences are found among the investment requirements of these classes of purchasers.

The primary aims of the most discriminating institutions, which often have large sums available for investment, are security and continuity of income. Marketability is ordinarily of secondary importance, since the investments of large institutions can be arranged so that successive annual maturities will provide such cash resources as may be required.

With banks and large corporations, considerations of first importance are liquidity, maturity dates, and security together with as liberal a rate of income as may be consistent with the features already mentioned. That these requirements are well met by carefully selected municipal bonds is evident from their large purchases of such securities.

Estates naturally vary greatly in their investment requirements,

but quite generally seek a conservative form of security. For such investments, municipal bonds are a favored medium. They afford ample opportunity to make selections conforming with the individual requirements in point of marketability, yield, and other features.

Individuals are usually interested primarily in the security and net income afforded by municipal bonds, with tax exemption and marketability varying in importance with the circumstances of the individual buyer. The United States Treasury Department's "Statistics of Income" for 1934 showed the importance of individuals as holders of the bonds of states and territories and their subdivisions. Such bonds were reported in income tax returns for that year from individuals with net incomes of $5,000 and over in an aggregate amount of $3,078,829,000.

Record of Municipal Debt—Volume

THE annual volume of municipal bond offerings in the United States has shown a large increase since the beginning of the present century. According to the most reliable figures available, the grand total of such bonds offered in 1901 was about $131,000,000, of which nearly $94,000,000 consisted of the bonds of cities and towns. Thereafter, the annual volume rose more or less steadily until in 1914, the year the World War began, total offerings were $474,000,000. In 1918, because of the halt called in municipal improvements when the United States entered the War, the total for the year dropped to less than $300,000,000. The following year again saw a resumption of the upward trend, and the billion-dollar mark was crossed for the first time in 1921, when the aggregate of issues for the year was over $1,200,000,000. The all-time record high for municipal flotations came in 1927, when offerings exceeded $1,500,000,000. The volume in later years has shown a decline from this level, with the shrinkage becoming more pronounced in the years following 1929 as the business depression proceeded. The low of the depression period was $520,478,023 in 1933, rising to $1,117,351,500 in 1936, both figures excluding Federal aid extended to states and municipalities. The recent upward trend in municipal emissions was moderately reversed during the first half of 1937, though a larger percentage of the total was for new capital than in the corresponding periods of 1935 and 1936.

Character of Offerings

THE purposes for which municipal bonds are issued have changed in importance considerably over a period of years. In 1932, according to an accepted compilation, bonds issued for the construction of highways, streets, bridges, etc., led all other classes as to purpose—19.33% of all municipal issues brought out during that year having been for such improvements. This represented a sharp reduction from the corresponding figures of 24.83% in 1931, and 29.09% in 1930. The purposes next in importance in 1932 were Funding (that is, consolidating and extending unfunded debt) which made up 18.90% of the total for the year; Improvement, 13.49%; Relief, 9.50%; Water, 6.55%; and Schools, 6.24%. Municipal bonds issued for relief showed a large increase beginning in 1932 while in 1933-34 and 1935 this classification occupied first place with percentages of 37.97, 25.37, and 12.09 respectively. Purposes in 1936 in order of importance were: streets, roads, and bridges, 12.45%; poor relief, 10.99%; schools, 10.80%; water, 5.17%.

The volume of refunding issues, which are not included in the foregoing paragraph, increased noticeably beginning in 1932, reflecting the decline in municipal expenditures and the effort to take advantage on existing debt of the low interest rates prevailing during much of this period. Obviously, in the case of refunding issues the issuing municipality does not increase its total debt.

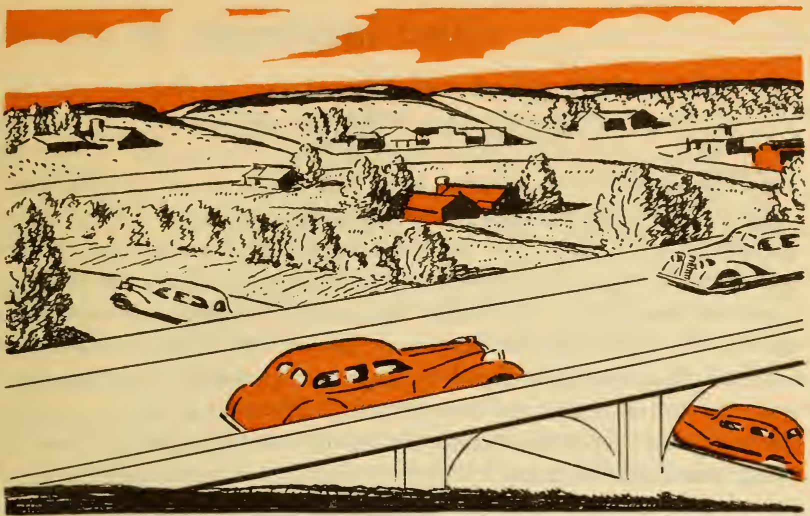
Price Trends

MUNICIPAL bonds are usually quoted in terms of yield, rather than price. The yield is sometimes referred to as the basis—thus a "5% basis" means a price level for all maturities to yield 5%. Yield, of course, varies inversely with price at a given coupon rate; that is, if the price is high the yield is low, and vice versa. A study of trends of municipal bond yields over nearly forty years reveals a number of interesting facts. A leading authority indicates that until recently the lowest average annual yield from the bonds of twenty large cities of the United States was 3.10% in 1901. Not until the close of 1936 was this figure exceeded when an average yield of 2.62% was attained among twenty representative

municipal bonds. Following 1921, the trend in yields—except for occasional temporary reversals—was upward. Even the enactment of the Federal Income Tax Law in 1913, specifically exempting municipal issues from payment of the tax, brought only a moderate decrease in municipal bond yields—not nearly so great as the tax exemption privilege might seem to have warranted. The reason generally accepted is that the increasing volume of municipal issues so affected the balance between supply and demand in the market that the value of tax exemption was soon offset, and within a few years was no longer clearly reflected in records of prices and yields.

In 1920–21, when security prices in general declined drastically, the average yield for the bonds of twenty large cities rose until, according to an accepted index, it stood on January 1, 1921 at 5.06%. In the period of rising municipal bond prices which succeeded, yields of the bonds of these same communities followed a generally downward trend to 3.87% on January 1, 1928, which was, of course, a time of exceptionally high prices on securities of nearly every type. On January 1, 1930, following the market crash in 1929, the figure stood at 4.23%. Subsequently the difficulties of municipalities in collecting taxes due to the depression increased, and as a result, yields increased, the average above cited, advancing finally to 5.48% on January 1, 1934. The extreme financial disturbances which shook the entire world during 1933 account for the erratic record of municipal bond prices throughout most of that year. From 1934 through 1936, the price trend was quite consistently upward, finally achieving all time record levels at the year end.

The severe slump in the first quarter of 1937, affecting all types of bonds for a time wiped out almost all the 1936 gains, the April 1st average yield of twenty municipal bonds standing at 3.40%, declining, however, as prices advanced, around July 1 to 3.05%.



Present-Day Considerations in the Choice of Municipal Bonds

As WITH all securities, investors generally have exercised much more care in the selection of state and municipal bonds since 1929 than was shown during the preceding decade. This increase in caution has been entirely proper. Although nothing occurred during the depression years to alter the high relative standing of municipals they shared naturally, to some extent, in the effects of the business depression.

It has always been a mistake, of course, to look upon municipal bonds as an invulnerable type of investment. Fully granting their inherent strength and their excellent record throughout a long period of years, it nevertheless would be an entirely unwarranted assumption to suppose that municipals could pass through a period of economic and financial upheaval like that of the recent past and come out wholly unscathed. That being true it may be timely to consider certain factors whose importance recent experience has emphasized.

Analytical Approach

THE choice of municipal securities demands a more deliberate, a more analytical approach than many investors have employed in the past. It is for the purpose of providing the principal data for such investigation and appraisal of the investment merits of municipal bonds that the present chapter has been prepared. The following discussion endeavors to present simply and concisely the considerations of primary importance at all times in the selection of municipal investments, with special emphasis upon those aspects which deserve careful attention under the exceptional conditions which have prevailed during the past several years.

Character of Community

IN ANY attempt to judge municipal bonds, a logical beginning is found in the character and record of the community.

How long has it been established? Is its permanence reasonably assured by the economic advantages in its position? Are its industries important, stable in character, and well diversified? What is the amount and character of its population? Does the population measure up favorably from the standpoints of intelligence, literacy, and thrift? What is and has been the character of the local government, particularly as regards the management of its financial affairs and the maintenance of its credit?

Each of these questions is of sufficient importance to justify careful consideration. Since so much reliance must necessarily be placed upon experience, an old community with a good record, other things being equal, must be preferred to one which is comparatively new. At the same time, a community which is enjoying a steady and a healthy growth may have much to recommend it over one which appears to be on the decline. A city whose revenues are drawn from many basic industries is obviously in a stronger position than one whose revenues are derived from a single industry or a small, closely related group of industries. A community which is distinguished for the industry, responsibility, and conservatism of its people is more likely to acquit itself well in financial matters than one whose population is deficient in these respects.

The broad general statements made here regarding communi-

ties may also be applied more or less directly to states when due allowance is made for the differences in the nature of the two classes of borrowers, and for the conditions surrounding their financing.

Debt History: Tax Lien

AFTER the foregoing factors have been examined, attention can be turned to the history of the community or state which issues the bonds. What has been its record for the prompt payment of its debts? If its record shows defaults in the past, what were the circumstances under which these were incurred? What was the ultimate outcome? It should be recognized here that circumstances such as local calamities, bank or financial failures sometimes affect temporarily the ability of a community to pay, when there is no question as to its good faith. The attitude of the community and the final result should be considered along with the fact of default.

Another question always of great importance in choosing municipal bonds is this: what is the nature of the tax lien securing the bonds? Is the bond secured by general taxes or by special assessment or benefit taxes? The investor should in no case remain in doubt as to this, since special assessment bonds, as a class, do not compare in desirability with general tax obligations.

Debt Restrictions

ANOTHER point which deserves attention is the question of constitutional or statutory restrictions upon the incurrence of municipal debt. Practically all state constitutions contain restrictions governing the purposes, extent, and manner in which the state and its subdivisions may borrow. The laws vary among the different states, some being decidedly more restrictive than others. This subject is sufficiently important to justify detailed treatment later.

A further point of importance concerns tax redemptions. What are the laws governing the right of any property holder to redeem property sold for taxes? Here again, wide variation is found among state laws. This is of great practical importance to the bondholder in the event of default, for the reason that property can not be sold with a clear title until the redemption period has expired. This operates to discourage the purchase of property at tax sales, since

prospective buyers are generally reluctant to tie up money in delinquent property when a comparatively long period of time must pass before title can be obtained. Long redemption periods, in thus reducing the demand for delinquent real estate, have the effect of prolonging the period during which taxes on the property may remain unpaid. This is, of course, unfavorable to the investor in the bonds of the municipality, for he depends upon the prompt collection of taxes for the interest and principal of his securities.

Financial Statement

TURNING next to a consideration of present indebtedness, we find a number of questions which demand answers:

What is the present total debt of the state or municipality? What part of the debt is self-sustaining? How does the *net debt* compare with that of other similar political units? What is the tax rate, the basis of assessment, the per capita debt—and how do these compare with the general average for similar political subdivisions?

To reach a sound judgment of any state or municipal bonds, it is important to have accurate information on all the foregoing points. In arriving at the net debt, of course, it is permissible to deduct bonded indebtedness incurred in the acquisition of municipally owned utility and similar properties earning enough to cover all debt service, and all operating, maintenance and other charges.

Experienced investors scarcely need to have pointed out to them the importance of the financial statement in determining the merits of state or municipal securities. With such purchasers, the financial statement has always received primary attention. In fact, the view has been expressed recently, by at least one institutional buyer, that financial reports, too often in the past, have been allowed to exclude facts which can not be expressed in figures, but which, nevertheless, have a vital bearing upon the desirability of the bonds.

Balanced Maturities

INTELLIGENT selection of municipal bonds requires that the investor give some thought to matters which might seem primarily the concern of the municipality rather than of himself. One such detail is the distribution of bond maturities. Formerly, it was

common for states and municipalities to bring out bonds with one date of maturity for the entire issue, providing for retirement through a sinking fund. Increasingly, the tendency has been to issue bonds with serial maturities distributed over a period of years. This method does not, however, exclude the possibility that a municipality may occasionally neglect to arrange an equalized schedule of maturities among the various issues which it has outstanding. It is entirely conceivable that a lack of foresight in this respect might lead to embarrassment if at some future time heavy maturities should fall due in a badly disturbed financial situation. This is a detail worth watching.

Balanced Budget

BECAUSE of the widespread difficulties which many states and municipalities experienced during the past few years in reducing their expenditures to conform with declining revenues, the investor should not omit to ask these questions: Has the borrowing state or municipality succeeded in balancing its budget? If complete balance has not yet been achieved, has reassuring progress been made in that direction? What is the attitude of the public officials toward additional expenditures and what is the disposition of the people toward voting approval?

Overlapping Debt

CARRYING his investigations further, the cautious investor will do well to inquire into the question of overlapping debt. If bonds which are being considered happen to be those of a city, what other debt creating bodies can levy taxes upon part or all of the property within the city? The significance of this point is apparent when it is remembered that the same property may be subject to tax levies for state, county, city, special assessment, school district, park district, and various other purposes.

Tax Collections

THE collection of taxes is a matter of immediate and high importance in judging municipal bonds. What sort of showing has the municipality recently made in collecting the

taxes levied? What percentage of the taxes for the past several years are delinquent? How does the showing compare with the record of tax collections in similar communities?

Unless tax collections for any community are distinctly reassuring, the investor should regard its bonds as somewhat less conservative until it is shown that the delinquencies have been corrected and are unlikely to recur.

Although very few communities, if any, throughout this country were able to avoid an increase in tax delinquencies during the depression years, a considerable number have made surprisingly good showings. Generally speaking, it was those communities which maintained a high credit standing that were in best position to offer new bond issues during the recovery years or to refund their debts on most favorable terms.

Behind the Figures

IT WILL be apparent from the foregoing outline that sound selection of municipal bonds does not readily reduce itself to pure formula. Careful study and analysis of the financial statement will reveal much—in some cases enough to disqualify the bond from further consideration. Where, on the contrary, the evidence presented in the financial statement is satisfactory, it is the part of wisdom, particularly under recent conditions, to extend the investigation to include many other factors. These, as our discussion attempts to show, will embrace many historical, legal, economic, social, and political questions.

The fact that these considerations can not be reduced to ratios and percentages does not argue against their vital importance. Economic advantages and disadvantages between communities might easily upset a striking similarity which exists on financial grounds alone. The character of populations and their political thought and leadership have exerted so profound an influence upon all human history that these can not be overlooked in the process of finding municipal investments that will survive bad times as well as good.

Financial Statements as a Guide in Selecting Municipal Bonds

IN THE selection of municipal bonds, the purchaser must ordinarily place great reliance upon the statistical summary known as the Financial Statement.

If the investor's choice is to be made intelligently, it is important not only that the Financial Statement be accurate and complete, but that the data it presents be interpreted clearly and conclusively. When the investor has completed his study, he should have in mind a picture of the community's fiscal situation and outlook which, with other essential data, will enable him to decide whether or not the bonds of this community offer the degree of security which his requirements make desirable and which is commensurate with the offering price.

The dangers of the purely statistical approach are, of course, precisely those which attach to all more or less mechanical rating systems. That such methods have proved inadequate is evident from the adoption by many large purchasers during the past few years of more thorough analytical methods in place of superficial methods of classification previously considered satisfactory. The

point we wish to establish here is that careful attention should be given to many factors aside from those which appear in the Financial Statements, and that these can not, for the most part, be expressed in figures nor in purely mathematical relationships. These will be dealt with in other chapters of this book. Our immediate aims are confined to the Financial Statement and to closely related considerations.

Illustrative Financial Statements

IN ORDER to lend concreteness to the discussion which follows, two Financial Statements are set forth below. The figures used are not those of actual communities. The relationships between the different items have been established, however, by reference to actual figures for numerous municipalities. The first of these specimen statements is very simple in make-up.

FINANCIAL* STATEMENT A

(As officially reported March 31, 1937)

Assessed Valuation		$145,348,368
Total Bonded Indebtedness (including this issue)		8,968,015
Sinking Funds	$973,855	
Net Bonded Debt		7,994,160

Population (1930 Census), 101,830

*NOTE: This designation is used here because it is the one which customarily appears in municipal bond offering circulars. A more appropriate title would be "Debt Statement." The term "Financial Statement" is more comprehensive, and therefore better descriptive of the complete reports, covering the condition and the operations of the community. The "Debt Statement" would thus be embraced within the "Financial Statement."

Financial Statement B is somewhat more inclusive than Statement A and more enlightening on that account. It is a hypothetical statement, and has been prepared for the purpose of bringing together most of the items now found from time to time in statements of this kind.

Financial Statement B

(As officially reported, March 31, 1937)

Full Valuation (estimated) 1936		$208,000,000
Assessed Valuation:		
Real Property	$83,425,622	
Personal Property	21,622,860	
Total		105,048,482
Total Bonded Debt, including this issue		6,558,463
Less: Water Bonds	$ 1,563,000	
Sinking Funds (for other than water bonds)	340,243	
Net Bonded Debt		4,655,220

Population (1920 Census)	94,630
Population (1930 Census)	101,490
Population (1937 Estimated)	102,000

Included in the general bonded debt are bonds aggregating $486,232 payable primarily from special assessments but constituting a general obligation of the city. There are outstanding building warrants in the amount of $114,650 against which there are sinking funds in the same amount, which funds are not included in the sinking funds shown above. We are informed that the Water Department has been self-sustaining, having been able to meet all debt service charges out of earnings.

The above statement does not include the debt of other political subdivisions which have power to levy taxes against the taxable property within the city. The city's share of the county's debt is approximately $30,000; School District B, which covers most of the city, has a debt of $1,759,000. The state has a relatively small funded debt.

Tax Collections

Year	Amount of Levy	% Collected During Following Fiscal Year	% Collected to March 1, 1937
1933	$926,993	88.44	96.04
1934	955,763	89.63	94.37
1935	983,625	92.16	95.33
1936	990,364	.....	*46.20

*Taxes payable in two installments, first half February 1, 1937, second half August 1, 1937. The city's fiscal year ends December 31.

"Officially Reported"

IN EXAMINING the foregoing statement, the phrase, "as officially reported" immediately catches the eye. It is evident that these figures were derived from official sources which is the primary assurance of their correctness. Communities are almost universally very jealous of their credit and realize that any wilful misrepresentation of material facts might easily reflect on their borrowing ability. Improved legal safeguards and accounting methods are also important factors in bringing about a higher degree of dependability than formerly.

It will be noted that the figures in the foregoing statements are as of March 31, 1937. The date is important, for obviously the value of the figures depends to a large extent upon their recency. New issues of bonds may be brought out, with the obvious result that a Financial Statement issued a year or more ago might show a debt or financial situation somewhat different from that which exists today.

Assessed Valuation

IN FINANCIAL Statement A shown on page 14, Assessed Valuation—that is the property valuation upon which the tax is calculated—is given as $145,348,368. Nothing is said as to whether this valuation is or is not identical with the estimated real value. In Statement B both Assessed Valuation and Estimated Real Valuation are given.

The following, a partial quotation from an opinion written a few years ago by a leading firm of attorneys specializing in municipal procedure, bears upon this point—" . . . The only effect the reporting of the property at an arbitrary percentage below the value actually found, has, is to increase the rate of the tax without in the slightest affecting the amount of taxes paid by the taxpayers.

" . . . The important factor is the valuation of the property for the purposes of taxation, and not the arbitrary percentage of that valuation upon which the tax levy is spread. That percentage might vary materially from year to year, causing considerable changes in the figure used for the basis of apportionment of the tax, without there being the slightest change in the actual value of the property subject to the tax burden.

". . . Theoretically the valuations found by the assessors as the true value should represent the actual market value of the property assessed. Unfortunately, as a practical matter, in no state do the assessors ever report the true value of the property for the purpose of taxation, even though they are required by law to do so. It is well known that the valuations reported by the assessors for the purposes of taxation, are always well below the actual value of the property . . ."

Thus it appears that the property valuations which are shown in a municipal Financial Statement usually can be taken as conservative, although there undoubtedly has been a tendency during recent years toward narrowing the gap between real and assessed valuations.

Personal Property

THE Financial Statements of most municipalities do not show a segregation between real and personal property. In specimen Financial Statement B, however, we do find a segregation. While this item is interesting for the purposes of this review, it is considered desirable that assessed valuation should consist for the most part of real property, and that any unusual proportion of personal and intangible property should be scrutinized with care. One danger connected with the latter type of property is that valuations, if too high, may not remain permanently subject to taxation. Intangibles are prone to flight from an excessive tax rate.

Total Bonded Debt

THE next item in Financial Statement B is Total Bonded Debt of $6,558,463. From this total several items are deductible. The Water properties, we learn from a supplementary note, pay the service upon their own bonds from their revenues after operating expenses; no provision need be made for them from general taxes. They add nothing to the debt burden and may properly be subtracted. The same might also apply to other self-sustaining debt.

Sinking Funds totalling $340,243 are also deductible from Total Bonded Debt, since they represent funds for the eventual extinguishment of an equal amount of the municipality's bonded debt, for which they were specifically reserved from taxes levied for that

purpose. Where there is any real question as to the value of the sinking funds, obviously these should not be deducted.

Not deducted from Total Bonded Debt, however, are $486,232 of bonds payable primarily from special assessments, but constituting a general obligation of the city. Where, as in this instance, they represent a contingent liability, it is sound and conservative practice to allow this item to stand as a part of Net Debt.

Unfunded Debt

BECAUSE of the unfavorable discrepancy between revenues and expenditures which existed during the depression years in many communities, the presence of unfunded debt assumed new importance. Consequently, we sometimes find supplementary information such as this—"The City Comptroller states that no unfunded debt will be outstanding after this financing."

The existence of unfunded debt is by no means always an indication that a state or municipality is running behind financially to a serious extent. It may merely indicate that warrants have been issued, not primarily because of an actual deficit for the fiscal year as a whole, but because the revenues of the municipality are much higher in some months than in others. The warrants serve, in this instance, as a means of equalizing the flow of funds rather than for making up a shortage.

Somewhat similar to the foregoing in their effect upon the debt position of a municipality are delinquent tax notes and judgments. At some future time, presumably, the former will be offset either through the collection of delinquent taxes or from satisfaction of the tax claim through the sale of the property. Judgments against the municipality, which should ordinarily attain no large total, eventually should be paid out of current revenues. Thus, neither item should constitute an addition to permanent debt unless subsequently funded.

Sinking Funds

IT WILL be noted in Financial Statement B that the Sinking Funds deducted from Total Bonded Debt did not include sinking funds applying to Water bonds. A moment's thought will show that this procedure is correct, since this type of self-sustaining debt

is not counted, in this instance, a part of the net bonded debt of the municipality. If, on the other hand, these water bonds should fail to be self-sustaining in the future, and should be included thereafter with the Net Bonded Debt of the community, then the sinking funds applying to the bonds would obviously be deductible.

A supplementary note under Financial Statement B refers to building warrants in the amount of $114,650, against which there are sinking funds in the same amount *not included with the sinking funds deducted* from Total Bonded Debt. Since this item very clearly does not represent an addition to permanent debt of the community, there can hardly be any question regarding the propriety of omitting it from the funded debt total.

Population

THE figures for population usually given are those for the last Federal Census. In the case of tax districts, the figures are given by the district officials. As the Federal Census figures become more or less obsolete, these should be supplemented, if possible, with later estimates. The population figures provide the means for calculations and comparisons on a per capita basis. These will be discussed in more detail in a later section.

Overlapping Debt

AS HAS been pointed out previously, the question of overlapping debt deserves consideration in attempting to determine the true situation behind municipal bonds. The property in a city which is taxed to pay principal and interest on the city's own bonds may be, and usually is, subject to tax also for the service of bonds issued by the state, county, or other overlapping political subdivisions. The second foot-note in Statement B indicates that the figures given in the tabulation do not include any overlapping debt; its approximate amount is however suggested by the reference to the debt of the County, School District, and State.

Tax Collections

ONE matter which has rightfully commanded wide attention recently and which is still important is that of Tax Collections. Financial Statement B, around which so much of this chapter is written, has appended a tabulated record—showing the

record of collection for the years 1933 to 1936 (payable in 1934 to 1937).

Two points deserve attention here. First of all, over 46% of the 1936 total has been collected despite the fact that the penalty date for the second installment at the time this report was made still lay some months ahead. The really significant figure for 1936 (payable 1937) will be the total after August 1, 1937. The penalty date or dates should be considered in examining all similar records.

The second point which should be made in this matter of tax collections is that percentages become illuminating only when contrasted with the general average. According to a report by a recognized agency, the median of year-end tax delinquencies in 1933 for 150 cities of the United States having populations over 50,000 was 26.35%, declining to 13.9% in 1936. Tax collections of 92.16% at the year end, 1936, as shown in the tabulation in Financial Statement B, are favorable when contrasted with the median of 86.1%.

Early Maturities

A STATE or municipality, like a private corporation, might easily be embarrassed by having a large amount of indebtedness fall due at a time when refunding was difficult or impossible. For this reason municipal bond circulars occasionally set forth the schedule of maturities over the next five years. If the municipality has exercised care in the distribution of its bond maturities, this schedule will not show too heavy a total of bonds maturing in any one year. When the maturities in any given 12-month period are exceptionally heavy, there may be no cause for concern if proper sinking funds are provided for retirement of the bonds.

Current Operations

IS THE state or municipality living within its means? Have the necessary steps been taken to bring expenditures down to revenues? If the budget has not been balanced hitherto, have retrenchment measures been taken which will insure balance in the future?

Among the many problems which public taxing bodies have to solve is that of keeping expenditures not merely within taxes levied, but within the sum total of the taxes collected and other revenues. While a balance between receipts and expenditures is

highly desirable, it must be recognized that many communities have been dealing in recent years with problems of great difficulty, for which immediate solutions have not always been easy to find. Occasionally, too, a community or a state can afford for a time to allow expenditures to exceed revenues. A case of this kind was the Commonwealth of Pennsylvania, which came into the depression years with an exceptionally large surplus that it deemed advisable to spend in part under the unfavorable economic conditions later prevailing.

Standards of Measurement

A "RULE OF THUMB" method sometimes used in judging municipal bonds is to reduce figures on municipal property values and indebtedness to a common denominator for purposes of comparison.

In Financial Statement B for instance, we find that the Net Bonded Debt figures out to be 4.4% of the assessed valuation of property subject to taxation. How does this compare with the percentages of both assessed and actual valuation for similar cities whose bonds may be up for consideration? Reducing the figures to a per capita basis, other enlightening comparisons may be made.

In these calculations, as previously emphasized, the investor should not lose sight of such considerations as overlapping debt. Above all, he should not fall into the error already referred to of reaching his conclusions on the basis of comparisons too mechanical in character. A $125 aggregate debt per capita may be less burdensome in one community than $100 in another. This may be due to differences in average wealth and capacity to pay, to conditions of stability, to character of people, and to many other factors not susceptible to mathematical representation.

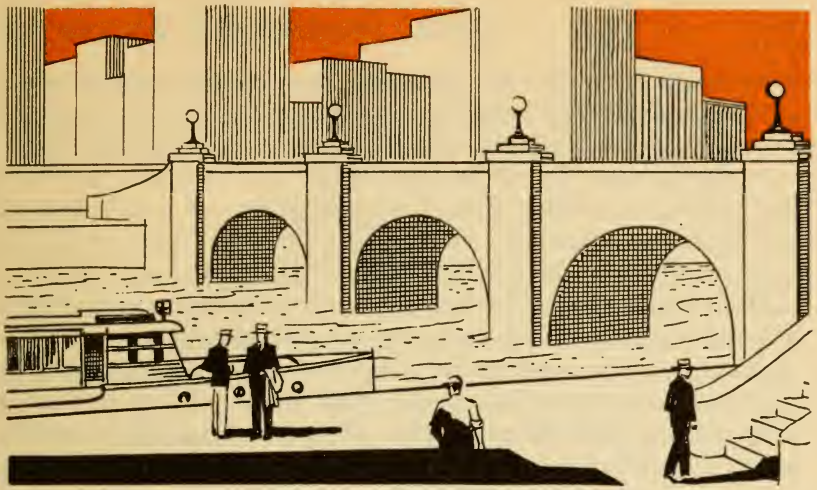
It may be interesting to know, for purposes of comparison, that the median amount of direct per capita net debt, plus overlapping debt, for a large group of cities having populations between 50,000 and 100,000 was reported by a well-informed agency as $97.46 for 1935. The corresponding per capita burden for cities of 100,000 to 250,000 was reported as $107.20; for cities of 250,000 to 500,000, $134.67, and for cities over 500,000, $144.16.

Legal Safety Limits

THE investor in municipals should bear in mind that a conservative debt ratio in a community today does not hold out positive assurance that the ratio will remain so permanently. He should not overlook the differences among state laws in the limits imposed upon the incurrence of indebtedness.

In New York State, counties and cities are limited for ordinary purposes to indebtedness not exceeding 10% of the assessed value of real estate. In Massachusetts the general limit for cities is 2½% of the average assessed valuation for the preceding three years, although this limit may be exceeded for certain purposes. In Illinois, cities, counties, school districts, and certain other municipal corporations are limited to an aggregate debt not in excess of 5% of the value of the taxable property, and some, under special enactment, are restricted to even less.

That these limitations should not be given more weight than they are worth, however, is evident from the fact that there are municipalities whose net debt ratios are under 5%, but which, nevertheless, have gone into default.



Factors Which Determine the Marketability of Municipal Bonds

BEFORE proceeding to a discussion of marketability, it may be well to define the term, and to distinguish it from another quality with which it is sometimes confused. Marketability, or salability, is properly understood to mean the readiness and promptness with which a bond can be disposed of by the holder. To put it very simply, an issue is marketable to the extent that it can be sold *quickly.*

Often confused with marketability is market or price *stability.* Market stability signifies the tendency of a bond to sell at or near a fixed level. Thus, a long term issue which is sold originally at 100, and subsequently varies from this price only a few points—perhaps scarcely more than enough to adjust the bonds to changes in the yields generally prevailing on similar securities—can be said to have a high degree of price stability. It should perhaps be noted at this point that highly conservative short term bonds tend to preserve greater market stability than equally well-secured long term bonds, because adjustments to changes in prevailing

yields require less change in price in short term investments than in long. Suppose, for example, that the current yield from first-class 20-year 3% bonds changes over a period of time from a 2.90% to a 3.40% basis. To reflect this change, the 20-year 3% bonds would need to decline from 101.51 to 94.23—or 7.28 points. A corresponding adjustment in yield for 5-year 3% bonds would call for a reduction in price from 100.46 to 98.17—or 2.29 points.

Marketability and price stability have no necessary connection, although both may, and frequently do, characterize the same municipal issue. The bonds of states and leading cities which enjoy an excellent credit standing usually rank high both in respect of marketability and price stability. When a bond trader remarks, however, that in a market of reduced activity a block of bonds can probably be sold "at a relatively good price, if it can be sold at all," he implies that the issue has a limited market, but that when bids do appear, the market is likely to be quite stable.

Factors in Marketability

THE principles which govern the marketability of state and municipal bonds are very similar to those which underlie the market for taxable securities. The credit of the issuer, its financial management, its size, the familiarity of the investing public with its bonds, the current supply and demand, the amount and distribution of the bonds, character of sponsorship—these and other factors help to determine the marketability of a municipal issue just as they do for any other type of bonds. It is with such influences as these that the following sections will be largely concerned.

Standing of the Borrower

A BORROWER, corporate or municipal, which has a widely known record for the prompt payment of its debts can, as a rule, sell its bonds readily at a relatively good price. Furthermore, the demand for these securities is likely to continue active, especially if wisdom and conservatism prevail in its current financial administration. Particularly important is management of finances in depression times, when solvency often calls for heroic effort on the part of the heads of the enterprise. The degree of the borrower's success or failure in keeping its fiscal house in order has a

direct bearing not only upon its ability to borrow at a favorable rate, but also upon the market for its bonds. This has been abundantly illustrated in the bond market of the past several years.

Distribution

THE amount and distribution of an issue of bonds play a major part in determining the character of its market. The larger the aggregate amount outstanding, usually, the wider the distribution; and the larger the number of different holders, the more active the market. Assuming comparable security, the bonds of a borrower held by several hundred individuals, banks, institutions, and corporations would obviously have wider recognition and acceptance than those held by only a few investors. While there might always be sellers among the hundreds, there would likewise usually be holders willing to acquire more of the bonds. There are also others, in all probability, who, having held these bonds in the past, would be willing to buy them again; and perhaps still others who have been made acquainted with the merits of the bonds through satisfied holders. Dealers and salesmen, of course, perform a valuable service in keeping available bonds before prospective buyers through periodical lists and quotations, and through verbal discussion. Bonds outstanding to the amount of many millions naturally are offered in the market most frequently, and receive such support most consistently.

A good many people entertain the erroneous belief that the listing of bonds upon one of the security exchanges is an assurance of marketability. This is not necessarily the case. Many listed bonds have a slow market, while hundreds of unlisted issues have a very active market. It is usually the case, unless bonds are outstanding in large amount and are widely distributed, that conditions are not right for a high degree of marketability; hence, listing will have little effect in correcting the situation. Domestic municipal bonds, excepting certain New York City bonds, are unlisted.

Current Supply and Demand

LIKE everything else that is bought or sold, bonds are subject to the operation of the law of supply and demand. The market for the bonds of almost any borrower might easily be impaired

by the issuance of its bonds in greater volume than can be absorbed; and the resulting weakness can be overcome only after the bonds are properly and permanently distributed. Similarly, a large volume of new offerings of all kinds, in the absence of a correspondingly strong demand, might temporarily derange the entire market, and force prices generally lower. When this happens, prices tend to stabilize as the balance is restored between supply and demand. Until balance is reestablished, the market will naturally remain unsettled.

Special Considerations

WHILE the foregoing are undoubtedly the chief factors affecting the marketability of all bonds, there are a number of others which are of sufficient importance to warrant brief consideration.

The maturity of an issue, as has already been suggested, may have a distinct influence upon marketability. Extremely short term issues usually meet a ready demand for the temporary investment of bank funds and similar funds, even though the issues may not be especially prominent. At a time of unusually favorable yields, under ordinary conditions, the preference may run to long term bonds for a time, for the reason that some investors will wish to avail themselves of the advantageous rates over an extended period of investment. The demand as between long and short term issues depends a good deal upon the conditions which obtain at any particular time.

The unit of any issue offered for sale by an investor has also an effect upon its salability. Among corporation bonds, the $1,000 piece is the standard unit of sale, although a round lot which is a multiple of $1,000, might be quickly salable—depending, of course, upon the bids in the market. An odd lot, or a bond of a denomination smaller than $1,000 usually finds a less satisfactory market than one of the round amounts mentioned. Among municipal bonds, blocks of $5,000 or multiples thereof are usually most promptly salable.

The operation of sinking funds sometimes exerts a strengthening influence upon the market. Sinking funds are frequently invested in the bonds to which they apply. Thus they represent just so much added to the demand which may exist from other sources. As pur-

chases are made for sinking fund purposes, the effect is to reduce the amount of bonds offered in the market and thus to improve the balance between supply and demand.

Another factor in strengthening the market for certain bonds is their acceptability for special forms of investment; such as the investment of funds of insurance companies, of trust funds, Postal Savings, savings banks, and other agencies whose purchases are limited by law to securities having specified qualifications.

A prominent factor in the demand for state and municipal bonds, of course, is their exemption from Federal Income taxes, and to some extent from certain forms of local taxation. This will be discussed in somewhat more detail later.

Apply These Tests to Municipals

HAVING set forth briefly in the foregoing outline the principal conditions affecting the marketability of all bonds, it may be helpful now to apply these tests to the marketability of municipal bonds in particular.

First, let us consider the standing and recognition which the borrower has in the eyes of the public. Generally speaking, the bonds of a prominent state or city in a good credit position are likely to have a good market, mainly because almost everyone knows the security, and because the investing public, at least, is familiar with the community and its record. Even the greatest of our states and cities, however, are subject to the same credit laws as persons or business concerns: they must be conservative and careful in the management of their revenues and expenditures if they are to enjoy strong credit. In short, they must not only be known, but *favorably* known among investors.

Smaller municipalities are likely to have less recognition among investors, and their bonds are correspondingly less widely marketable. The market for such bonds, even though the financial statements and other facts behind them are all that can be desired, is usually of a more restricted character. The demand for them is thus likely to be confined more to the smaller group of investors who know their merits, or who will take the time and trouble to investigate.

"For Investment"

MUNICIPALS, perhaps more than any other major type of bonds, are bought for *permanent investment.* This means that they are bought for security and income by investors and institutions who put them away in vaults, where, except for the clipping of coupons, the bonds often remain until redeemed. Once a high-grade issue is properly distributed among permanent investors, only a comparatively small percentage of the bonds may come back into the market. Municipals, moreover, are not so extensively pledged for bank loans; they are not a type of security favored by the trading element which is constantly buying and selling in the securities markets. All this helps to explain the relative stability of municipal bond prices.

Market Conditions

IN SELECTING municipal bonds, as in choosing any other kind, the investor must consider the changes in general market conditions which may affect his securities. Mention has already been made of supply and demand. The demand for municipals has undoubtedly been increased during recent years by the relative scarcity of new issues of high-grade corporation bonds. The effect of this has been to divert more available funds to tax-exempt bonds. For a time, the investor had little choice among new issues, beyond municipals and U. S. Government securities. Reasoning from this circumstance, it seems possible that new offerings of taxable bonds and stocks in more normal ratio to municipal offerings might have some effect in lessening the demand for the latter. These things are, of course, problematical both as to their occurrence and their effect.

Effect of Tax-Exemption

THE fact that state and municipal bonds are exempt from present Federal Income taxes is, of course, an important factor in creating a demand for them and providing the basis for a broad market. Because of the increased burden of debt which the Federal Government has been assuming in recent years, and the

prospect of higher Federal taxes, it seems highly probable that the present exemption of municipal bonds from Federal Income taxes may at least be no less valuable in the future than in the past.

State and municipal bonds are sometimes exempt from local taxes in the state of their origin, sometimes taxable. In New York, for example, the bonds of New York State and the municipal corporations therein are exempt from taxation for town, county, municipal, or state purposes under existing laws. In Illinois, on the other hand, the bonds of Illinois and its political subdivisions are subject to tax. In Pennsylvania, most municipal bonds are brought out as "tax-free" in the State, the issuing municipality assuming the four-mills tax authorized by the Pennsylvania Act of 1913. Such bonds are tax-free due to the fact that the issuing municipality has assumed the payment of the tax. In Ohio, bonds of the State itself and of Ohio municipalities, if issued prior to January 1, 1913 are exempt; while those issued later are subject to an annual levy of 5% of the income yield, or, if unproductive, to two mills based upon their market value. In Michigan, the bonds of Michigan political subdivisions and the State Soldiers' Bonus and Highway Bonds are exempt from taxation. Municipal bonds originating outside of Michigan may be exempted permanently upon payment of a specific tax of ½% of the par value. In Iowa, bonds issued by municipalities, school districts, counties, etc., within that State are exempt from the Iowa personal property tax which applies to other types of securities, such as municipal bonds issued in other States, corporation bonds, etc. In Massachusetts, bonds of the State itself, issued since January 1, 1906, as well as local municipals issued since May 1, 1908, are exempt except, generally speaking, when held by commercial banks, trust companies, and certain other corporations. These are merely illustrative examples. Among the remaining states, there is a wide variation in the treatment of state and municipal bonds for purposes of local taxation.

Institutional Qualifications

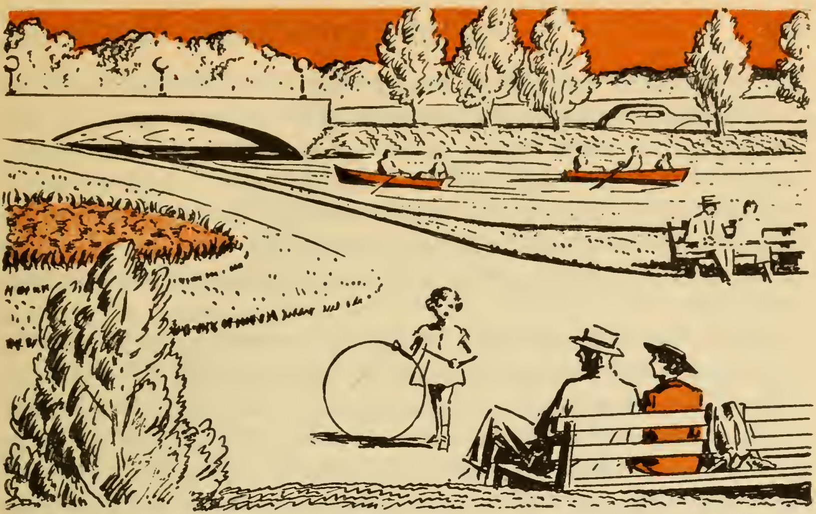
THE acceptability of many municipal bonds for the investment of trust funds, the funds of savings banks and insurance companies, and similar institutions is an important factor in sustaining a broad market for high-grade municipal bonds. The importance of this is discussed in a later section.

"Spread"

THE bonds of leading states and cities which have strong credit standing generally enjoy both an active and a "close" market. By a "close" market is meant a narrow spread between the bid and asked prices. The "spread" in the case of a widely known, actively traded state or city bond will naturally be less than in the case of a bond of a smaller, less conspicuous community. Generally speaking, the narrowness of the spread is a reliable index of marketability. Another fact significant from the market standpoint is that new issues of municipal bonds generally show the distributing house only a small margin of profit—in many cases only a fraction of 1%. This in itself is an indication of the narrow profit on which dealers are accustomed to operate in the distribution of municipal bonds.

The Distributing House

IT MIGHT be supposed that a municipal bond is either desirable or undesirable purely on its own merits, regardless of where it is bought. So far as marketability is concerned, however, this is not wholly the case. The distributing house does play a relatively important part in providing a secondary market for the municipal issues it has distributed. The distributing house does not, of course, occupy the more or less permanent banking position with a state or municipality which is common between investment houses and corporations, and for this reason, it can hardly be said to have the degree of market responsibility usually assumed in the case of corporation issues. Nevertheless, the reliable distributor of municipals must not only use his knowledge and judgment in choosing issues of good quality, but, being desirous of serving his customers and keeping their good will, he also feels an obligation to undertake to do what he can toward maintaining a secondary market for the bonds after they are distributed. This is especially important in the case of smaller issues, some revenue bonds, and the bonds of various special districts for which there is not a broad and spontaneous market demand, but which, nevertheless, offer many investment advantages when they have a reasonably active market.



Legal Safeguards Surrounding Municipal Bonds

THE LEGAL SAFEGUARDS which have been thrown around municipal bonds are the outgrowth of experience extending over several generations. Purchasers of this type of obligation discovered long ago that the terms written into the bond itself might be legally air-tight and yet fail to provide adequate security. The prompt and thorough discharge of the loan contract, it was found, sometimes depended upon influences arising *outside* the contract itself. Consequently, great effort and ingenuity have been employed throughout many decades by investment houses, bond attorneys, legislatures, and others interested in protecting investors against those external dangers which have sometimes prevented the carrying out of the original intent and purposes of the bond.

The dangers referred to have nearly always come to the surface in times of economic and financial stress. In periods of buoyant prosperity, naturally, public debt is scarcely ever burdensome.

The revenues for its discharge are usually raised without difficulty and without hardship to the taxpayer. When depression conditions prevail, on the other hand, the free and easy attitude of the taxpayer is likely to be replaced by a sharply critical disposition. At such times, the political demagogue may find in the distress of the people a fertile field for agitating against the discharge of public debts and for ferreting out loopholes by which debt payment can be evaded.

Luckily for the holders of municipal bonds today, most of the old legal battles have ended in clearly establishing the bondholders' rights. The old weaknesses have generally been corrected by appropriate legislation. It may be said that investors in municipal securities came into, and emerged from, the depression period of the 1930's with their rights more clearly defined and their position protected by stronger legal bulwarks than ever before in history. This fact probably accounts for the comparative absence today of political agitation against the payment of just public debts, and the generally fair attitude of taxpayers even in communities that have encountered difficulty in meeting the service upon their debt.

Before proceeding to review and discuss the principal legal safeguards surrounding municipal bonds, it should be made clear that the present discussion will be confined wholly to a consideration of the nature and intent of the constitutional and statutory provisions, without, however, proceeding to cover the subject of legal remedy, or, in other words, the recourse which the bondholders have in the event of default. This latter question will be taken up later in a separate chapter in this booklet.

Historical Development

IT IS to the history of state and municipal finance that we must look for the causes which led to the legal bulwarks which have been thrown up for the protection of investors in municipal bonds.

The debt history of our states began before American cities became prominent as public borrowers. The first period of default in state debt came between 1840 and 1842—following the panic of 1837. A second period of difficulty and default in state bonds came after the Civil War. Prominent among the causes of trouble with state bonds have been over-issuance; the incurrence of debt for the purpose of aiding private companies, such as banks

and railroads; and in the South, following the Civil War, the frauds, misappropriation, and incompetency which attended the regime of the "carpet-baggers."

Viewed from a long historical perspective, the record of municipal debt, considering the total amounts issued, shows up—at least until the recent depression—better than state debt. This is doubtless partly accounted for by the shorter history of municipal financing and the fact that state bonds were issued in large volume in the earlier part of the last century and therefore in a less responsible, less stable, period of our history. Causes for municipal default have included alleged illegality of issuance—usually, no doubt, a loophole for evasion rather than a real cause; over-issuance, frequently resulting from speculation in real estate; issuance of bonds to aid railroads, and for other questionable, non-public purposes; lack of stability among small communities; local disasters; issuance of bonds for irrigation, drainage, and similar projects involving considerable risk. Now and then there have been cases of plain bad faith.

In considering the history of the past two decades it should be recognized that the shifting of a substantial part of the population of the United States from the rural districts to urban centers has exerted a profound influence upon the volume and character of municipal financing. The rapid growth of city populations has necessitated the vast extension of such facilities as water service, street paving, schools, public buildings, and sewers, and the capital to pay for such extensive improvements has had to be raised for the most part through the sale of bonds. Similarly, the development of the automobile has compelled the states to carry out enormous highway building programs. The result of all this has been to make our states and their subdivisions borrowers on a greater scale than ever previously.

The immensity of the bond financing involved and the almost universal dependence of our people, directly as holders of bonds, or indirectly as owners of bank deposits or holders of insurance policies, emphasizes more than ever the vital need for preserving the soundness and the enforceability of our state and municipal obligations totaling many billions of dollars.

Among the outstanding developments in the field of state and municipal bonds since the conclusion of the World War have been the following:

The issuance of bonds by various states for the purpose of paying service bonuses to ex-soldiers;

The heavy municipal borrowing done by Florida communities during the real estate boom which culminated in 1926 and resulted in numerous defaults;

The difficulties encountered in the early 1930's by leading American municipalities, including New York, Chicago, Philadelphia and Detroit;

The issuance by states and municipalities of welfare and relief bonds on a large scale—in 1936 for example, according to one authority, to the extent of $122,648,565 (not including loans extended by Government agencies); in 1935, $147,496,146; in 1934, $221,444,411; and in 1933, $197,646,945.

Refunding operations on a large scale during the post-depression period to equalize debts structures or to take advantage of favorable money rates prevailing during that period.

From a consideration of these developments it would seem that the problems of state and municipal finance change—superficially, at least—with the times. It is a question whether all the troubles which arose from the Florida boom could have antidotes in law. Likewise, the recent difficulties of some of our leading cities, being so obviously a result of extraordinary conditions, could hardly have been anticipated fully through the foresight of our lawmakers. The issuance of bonds for the payment of soldiers' bonuses, for relief, and, to a lesser extent, for such purposes as housing and the acquisition of grain elevators, can hardly be regarded as the most desirable use of state and local credit. Much of the relief borrowing, of course, may be explained on the grounds of necessity. Encouragement is to be found also in the fact that the aggregate of loans for extra-governmental purposes constitutes, after all, only a small part of the total state and municipal debt.

General Purposes

THE primary purpose of constitutional conventions and legislatures in establishing legal safeguards for municipal bonds is protection of the credit of the borrowing community. This in itself

is a matter of great practical importance. The state or municipality which has an excellent debt history and maintains unblemished its record for the prompt, scrupulous payment of its obligations, naturally occupies a preferred position in the capital market. A political subdivision of this character can usually secure financial accommodation at substantially lower cost than a similar community having a less satisfactory history.

Further purposes behind the legal safeguards set up to protect the integrity of municipal loans are these:

> To eliminate so far as possible the opportunity for fraud in the issuance of securities;
>
> To assure the borrowing community fair prices and terms upon the bonds sold;
>
> To guard against over-issuance of bonds and the disasters which might easily result from burdening a community with debt greater than it can discharge.

Finally, all legal safeguards are established for the protection of those who invest in municipal bonds. The relationship between the borrowing community and the purchasers of its bonds is somewhat similar to that which a commercial house seeks to maintain with its customer: confidence must be preserved and the satisfaction of the purchaser must be assured. If the community fails in either, it is sure to suffer serious impairment of its credit standing. This is merely another way of saying that it will find it more difficult to borrow in the future, if it can secure accommodation at all; and that it will have to pay higher rates upon what it does borrow. A serious blemish upon the credit record of a state or municipality, moreover, is long in wearing off; its effects often persist far beyond the generation of investors directly affected.

To Assure Validity

TURNING now to a review of the legal safeguards, it will be well to note briefly the provisions made in many states to assure the validity of the bonds issued. Communities which have in the past made up their minds to avoid payment of their debts have sometimes sought diligently for technical loopholes which might give them an excuse for refusing to pay. Consequently, the

statutes of many states contain detailed requirements which must be satisfied before bonds can be offered for sale. These may include the manner of submitting the proposed issue at an election, referendums, petitions, advance notice or advertising of the proposed sale, restrictions as to purpose, and limitations as to the incurrence of debt not to exceed a stated ratio of the value of taxable property. A favorable sign is the growth of constitutional and statutory measures designed to protect the investor from the possibility that the municipal bonds he holds may be attacked at some time in the future on the grounds of illegal issuance. In addition to prescribing the procedure to be followed in issuing state and municipal bonds, the constitutions of some states require that the bonds have endorsed upon them a certificate signed by the auditor or other responsible officer certifying that the bonds have been issued pursuant to law and are within the legal debt limit. Among states having such laws are Texas, Georgia, and North Dakota.

Validity is further safeguarded by the required recital in the bonds themselves, the courts having held that the recital of regularity bars the issuing municipality from pleading invalidity when the bonds are held by an innocent holder for value.

A strong point in favor of investors holding American municipal bonds is the general attitude of both Federal and state courts that a mere technical error shall not constitute grounds for repudiation.

To Assure Payment

AMONG constitutional and statutory provisions intended to insure payment of state and municipal bonds are the limits placed upon the amounts issuable. The limit may be fixed at a certain amount or, as is usually the case, a percentage of the value of the property subject to tax. In some cases a limit is placed upon the amount of taxes that may be raised for the service of bonds. This, obviously, is highly objectionable and invites trouble; the limitation should be placed, not upon the taxes that may be levied, but upon the amount of bonds that may be issued. New York and New Jersey, in general, very properly place no limit whatsoever upon the levy of taxes for the service of debt which has actually been incurred. Limits upon the issuance of state bonds are perhaps best written into state constitutions, where they can not be changed by legislative action. In most cases, however, the power of fixing debt

limits has been delegated to legislatures. This gives it flexibility, but also leaves it more open to abuse.

Statutes which authorize the issuance of bonds usually provide for the levy of taxes sufficient to pay principal and interest upon the bonds. This is an important point, for when the laws fail to provide for an adequate levy, the courts are unable to grant a remedy.

Another desirable provision in the laws governing the issuance of municipal bonds in some states is one which limits the maximum life of the bonds to a period not greater than the approximate life of the improvement for which the proceeds are to be used. Where bonds are permitted to be issued for a much longer period than the life of the improvement, the following generation may be compelled to pay for benefits which it is unable to enjoy. The statutes of New Jersey, Massachusetts, and North Carolina have provisions covering this point. Serial bonds are also mandatory in these states, and in New York as well. One of the advantages of serial bonds lies in the fact that they provide, in effect, their own sinking fund and are therefore free from the dangers of mismanagement and misappropriation sometimes associated with sinking fund issues.

Proper or Improper Purpose—Most states expressly forbid their municipalities to lend money or credit to any private company or person, or to own stock in any private enterprise or to assume its debts. In view of the sad experiences of our states in subsidizing private undertakings during earlier periods of our history, there can hardly be any doubt as to the desirability of rigid laws covering the purposes for which public funds can be employed.

One of the best examples of the unwise use of state credit is to be found in the period of state borrowing which led to what is commonly known as the "first period of default." This early period of financial difficulty among the states occurred in the years immediately following 1840. Between 1820 and 1838, eighteen states had authorized or contracted indebtedness totaling about $170,000,000—not a staggering figure today, it is true, but nevertheless a large one in view of the undeveloped state of the country at that time. The debt referred to was incurred as a result of the widespread fever for "internal improvements." The proceeds of the loans were spent largely for the construction of canals and roads, and for the establishment of banks. Subsequently, most of the banks failed. Financial troubles overtook the states which issued

the bonds before many of the canals and roads were finished, and some of those which were finished proved to be far less successful and productive than had been expected. The succession of defaults which followed should stand as a warning for all time against the reckless and improper use of state credit, and many of the legal safeguards which exist today are the direct outgrowth of that unfortunate period.

To Assure Full Value to the Community

THE private sale of municipal bonds is often prohibited by statute except under certain conditions. The private sale of short term paper is usually permissible. Because of the danger of loss to the municipality through private sales, statutes usually require that public notice be given of an intended sale and that the award be made on the basis of competitive bidding. Most statutes also require that sales be made at not less than par. Where the statute makes no specific provision on this point, however, the bonds may usually be sold for any price they will bring, if the terms are not so unfavorable as to subject the municipality to a usurious charge for the money borrowed.

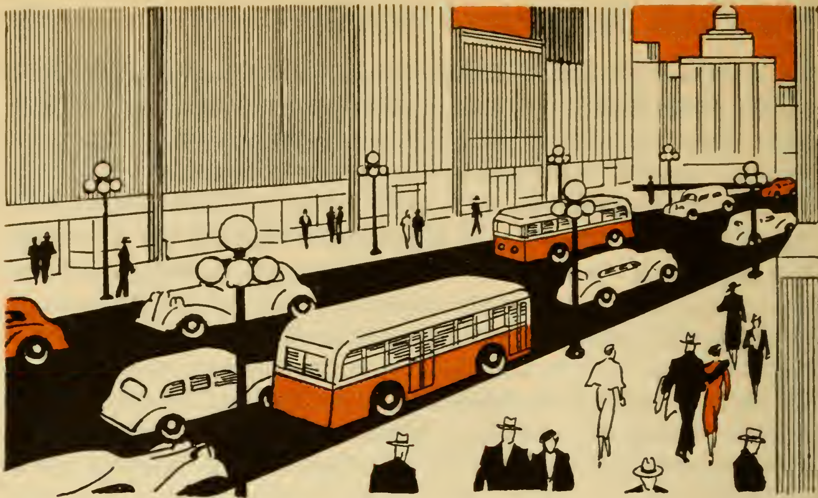
How Accomplished?

THE restrictions upon the power of states and municipalities to borrow through the issuance of their obligations are imposed either by provisions in the constitutions of the states or by their statutes. Constitutional provisions are less subject to sudden modification, and therefore less liable to change at the whims of legislators. Thus, they serve to exert a steadying influence, and reduce the likelihood that the state itself, or its municipalities, may rush into an unwise program of borrowing. Statutes, on the other hand, have the advantage of greater flexibility, although, as has already been pointed out, they are open to the possibility of quick change, which implies also the possibility of ill-considered change.

It should be observed before leaving the subject of municipal debt that the legal safeguards which have been outlined in the foregoing sections assume great importance in their application to the obligations of states as well as to those of municipalities. The state, be it remembered is sovereign. It can be sued by another state,

but not by an individual without its consent. The individual holder of state bonds may be without legal remedy in the event that the state does not live up to its agreement. Because of these facts, restrictions upon the debt-incurring power of a state are of importance to the bondholder. A state which is rigidly hemmed in by justified legal limitations is less likely to become over-extended than one which is subject to inadequate checks, or none at all. By thus removing or reducing the opportunity for unwise borrowing, the danger is also diminished that the state may at sometime in the future deal with its bondholders in an arbitrary manner. The fact that the bonds of one state are frequently held by other states or their institutions, of course, decreases the chances that a state would be permitted to neglect its promises without challenge from bondholders.

The Legal Opinion—The generally satisfactory record maintained by the municipalities of the United States in recent years was contributed to by the meticulous care exercised by attorneys specializing in municipal bond procedure. So thorough is the work of the best of these firms that irregularities and oversights in the issuance of municipal bonds are nowadays comparatively rare. The legal opinions which accompany municipal bonds today represent investigation and examination of all points of law which are so minute and complete that even the most experienced professional buyer often feels justified in passing beyond the strictly legal details and confining attention to the broader investment aspects of the bonds under consideration.



Recourse in Event of Default of Municipal Bonds

STATE AND MUNICIPAL BONDS universally call for the repayment of principal at a specified time, for the payment of interest at fixed intervals, usually semi-annually, and, generally, for the discharge of certain other requirements and conditions which are elements in the loan contract. Failure to comply with one or more of these obligations constitutes default. Contrary to what some might expect, however, default in the payment of an installment of interest does not automatically mature the principal; nor does failure to pay one maturity of serial bonds mature the remainder of the series. This is not in accordance with what happens in the case of corporation bonds, for default in the payment of interest on the latter usually makes the principal due and payable at once.

Failure to meet interest requirements promptly was the most common cause of default among municipal bonds during the difficulties of the depression years. While the aggregate amount of

bonds in default as to principal during those years was by no means small, the total was, nevertheless, far below that of the bonds which fell from grace through the inability of municipalities to raise sufficient revenues from taxation to meet current operating expenses and requirements for bond interest.

It is estimated that at the peak around $2,000,000,000 par value of municipal bonds were in default as to principal or interest, or both; also that the amount of principal and interest due but unpaid was approximately $200,000,000. Formidable as these figures appear, they are far less disturbing than they might be when they are considered in relation to the aggregate of state and municipal bonds outstanding. The gross state and municipal indebtedness is estimated to total somewhere near $20,000,000,000, though in 1932–1934, when defaults were most acute, the totals were from one to two billions less. It should be considered also that a substantial portion of the bonds included among the $2,000,000,000 in default were those of Detroit, Mich., various Special Districts of Cook County, Ill., and State of Arkansas, all of which have since been readjusted and restored to good standing by extensive refunding or readjustment operations. A compilation dated Feb. 1, 1937, shows no state debt in default, and of the municipal bodies in default, approximately two thirds represented counties, cities and towns, and school and other districts; the remaining one third, comprised reclamation, levee, irrigation and drainage districts, together with special assessments. It is noteworthy that about 80%, in number, of these defaults were confined to ten states and that nine states showed no defaults at all.

Bondholders' Committees

WHEN the bonds of states or municipalities go into default, committees are frequently organized for the protection of the bondholders. This course is especially likely to be followed in the case of large municipalities, whose defaults affect literally thousands of investors. Such committees are not always organized among the holders of the bonds of smaller municipalities, especially where difficulties of the local government have been unavoidable and where every disposition is shown to cooperate with the bondholders and to keep them closely informed of all developments.

One of the chief advantages of the protective committee is that

it brings the individual bondholders together for concerted and hence more effective action. Such a committee, furthermore, can act more efficiently and economically for all who deposit their bonds with it, and can employ the legal or other specialized talent necessary for the effective prosecution of its work. When such a committee represents a substantial majority of the bondholders, moreover, it has more standing before the courts than a bondholder would have individually.

Legal Remedy

HAVING discussed in previous chapters in this book the nature of a municipal obligation and the legal bulwarks designed to protect the investor against ill-advised issuance and similar hazards, it is appropriate now to turn to the question of the legal remedy at the disposal of the investor if default occurs. Although very few municipal or any other type of bonds are purchased with the expectation that default will occur, the intelligent investor can scarcely fail to recognize its possibility. If this possibility did not exist, obviously, all the careful definition of rights which appears in the bond and all the legal safeguards surrounding it would be superfluous.

Since legal remedy varies with the type of obligation affected, the several classes will be discussed briefly in order.

State Issues

IN CONSIDERING legal remedy in connection with state issues this fact immediately assumes prominence—namely, that the state is sovereign, and can not, therefore, be sued by an individual without its own consent.

From this it is apparent at once that much depends, in the case of a state, upon the *will* to pay. A state may have the ability to pay and still lack the inclination to meet its obligations.

Despite the handicap under which the holder of a defaulted state obligation labors, his situation is, in practice, usually not so circumscribed as it may seem. There remains, in the first place, the possibility of action against the individual officials of the defaulting state. In the second place, the inability of an individual to bring suit against a state does not extend to other states; and since bonds

of the defaulting state may be held by other states, there is nothing to prevent action on the part of any such state which faces the prospect of loss.

Municipal Issues

WHEN default occurs in a municipal obligation—the bond of a county, city, town, tax district or other local taxing body—the problem of the holder is not complicated by any question of sovereignty. Any such political subdivision can be sued without its consent. Upon the failure of such a taxing body to pay interest or principal when due, assuming its ability to pay, the bondholders or their representatives may institute proceedings in the court having jurisdiction, usually a Federal court, to establish their claim and to apply for a writ of mandamus ordering the municipal authorities to levy taxes sufficient to satisfy the claim. The writ of mandamus is simply a direction by the court to the local officials to perform certain functions, and the officers receiving such direction are allowed no discretion in the matter.

Sometimes the ordinary processes of law are considered to provide the bondholders with an adequate remedy. In such cases the usual procedure is to secure a judgment which establishes the amount due the creditors. Then, if the municipal officers fail to levy the taxes required to satisfy the claim, the creditors are usually given a writ of mandamus. If the orders contained in such a writ are not obeyed, the officials of the local unit are liable to jail sentence for contempt of court.

A point which was made in a preceding chapter, and which is worth repeating here, is that when the law fails to provide for an adequate levy of taxes, the courts are unable to grant relief. If there is a limit upon the tax rate, the officials of a municipality can not be required to exceed it. Needless to say, the careful bond house, in its original purchase of municipal bonds direct from the issuing communities, exercises diligence to ascertain that limitations, where present, nevertheless afford reasonable security.

Because of a common and rather widespread misunderstanding of the matter, it should perhaps also be pointed out that direct tax municipal bonds are rarely secured by a mortgage lien upon property. In infrequent instances municipal issues have been secured by the mortgage of specific property, but such cases have been few. It is distinctly an error for the investor to assume that municipal bonds

generally represent a mortgage lien upon all the taxable property within the municipality—his is a tax lien rather than a property lien. As a practical matter, creditors of a community must ordinarily look to the proceeds of taxation for the satisfaction of their claims, and not to attachment of property within the community.

Among other factors operating to provide the municipal bondholder with an effective remedy (except perhaps in extreme emergency) is the provision in the Constitution of the United States which prohibits any state from passing any law which impairs the obligation of contracts. If adequate taxing power exists when bonds are issued, this power may not be destroyed by legislative enactment.

Even though the claims of bondholders may have little support on a purely legal basis, relief is sometimes given the holder of defaulted bonds through legislative action. This is especially likely to be true where the claims are morally just and equitable, or where there is intelligent recognition of the fact that fair treatment of the investor under all conditions is essential to maintenance of good credit for the municipality. Legislatures are powerless, however, where constitutional limitations on the tax rate stand in the way of relief. Yet even where constitutional limitations exist, there is, of course, always the possibility of altering the situation by amendment through popular vote.

Revenue Bonds

WHEN bonds are issued by a municipality which are solely payable, as to both principal and interest, from the revenues of a utility property, the strength of the investor's position depends upon the enforceability of any covenant made by the municipality to maintain, at all times, rates sufficient for service upon the bonds. There is excellent legal authority for the statement that holders of such bonds can proceed to enforce their rights by means even more simple and direct than those at the command of holders of general tax municipals. Failure to maintain rates at an adequate level opens the way for mandamus proceedings similar to those described in the preceding section.

The right of foreclosure upon municipal utility properties would naturally exist only in those cases where plant and equipment are actually mortgaged to the bondholders.

Special Assessment Bonds

BONDS which are payable solely from special assessments are considered to occupy a distinctly weaker position from the standpoint of legal remedy than any of the classes described in the foregoing sections. It is difficult to make generalizations because of the varying conditions under which such obligations have been issued. Ordinarily, assessments are levied against property benefited by an improvement in an amount sufficient to meet the requirements of principal and interest upon the special assessment bonds which are issued in anticipation of the collection of such assessments and to provide some margin against delinquencies. If property owners fail to pay the assessments, collection of the assessments must be enforced by the sale of the property under the laws provided for that purpose by the particular state in question. The municipality is only required to make payments on the special assessment bonds as funds are collected from the properties against which the respective assessments have been levied. If the funds from the assessments are collected and diverted in whole or in part to some other use, the recourse of the holders of special assessment bonds is through filing a suit against the municipality for breach of trust. Deficiencies that occur in an assessment due to the fact that a sufficient amount of assessments was not levied in the first instance to pay the cost of the work can usually be provided for by the levy of an additional assessment, but this procedure is quite difficult. Defaults upon special assessment bonds are due usually not to failure to levy a sufficient amount of assessments, but to the diversion of funds from the use intended or to the inability of property owners to meet their payments as they become due.

Municipal Bankruptcy Act

A DISCUSSION of the legal remedy of holders of defaulted municipal bonds would be incomplete without some reference to the amendment to the Federal Bankruptcy Act which became operative August 16, 1937. The Act deals with the composition, through bankruptcy proceedings, of the indebtedness of insolvent taxing agencies such as drainage, levee, water, irriga-

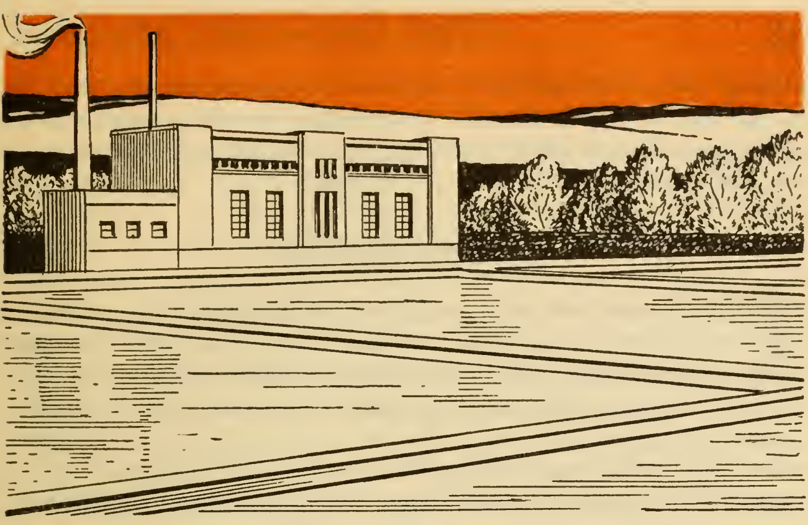
tion, sewer, road, school, port, and similar improvement districts; also that of certain towns, cities, boroughs and townships.

The Act terminates in 1940 and supersedes one of similar purpose which became operative May 24, 1934 and which was later held unconstitutional by the United States Supreme Court on the grounds that it interfered with the States in the control of their fiscal affairs.

The new measure seeks to avoid the constitutional flaws of the original Act. The taxing agency itself is the only instrumentality which can seek its benefits. No involuntary proceedings are allowable, and according to the House Committee on the Judiciary "no control or jurisdiction over that property and those revenues of the petitioning agency necessary for essential governmental purposes is conferred by the bill (Act)."

Compositions under the Act are approvable, again quoting the House Judiciary Committee "only when the districts or agencies file voluntary proceedings in courts of bankruptcy, accompanied by plans approved by 51% of all the creditors of the district or agency, and by evidence of good faith. Each proceeding is subject to ample notice to creditors through hearings, complete investigations, and appeals from interlocutory and final decrees. The plan of composition cannot be confirmed unless accepted in writing by creditors holding at least 66⅔% of the aggregate amount of the indebtedness of the petitioning district or taxing agency, and unless the judge is satisfied that the taxing district is authorized by law to carry out the plan, and until a specific finding by the Court that the plan of composition is fair, equitable and for the best interests of the creditors."

These are the barest outlines of the Act, which itself should be studied for details by those interested. Based on experience under the original Act and the greatly improved status of municipal credit now prevailing, it appears improbable that the new measure will be availed of at all widely. It is significant chiefly as evidence of an effort to make available to distressed municipalities the same general remedies that apply to corporate borrowers.



Revenue Issues—a Self-Supporting Type of Municipal Bonds

REVENUE BONDS* may be defined for the purposes of this discussion as obligations which are issued by states or municipalities for the construction, purchase, or improvement of revenue producing properties, generally consisting of water works, electric light and power systems, toll-bridges, sewer projects, gas systems, and other publicly owned and operated enterprises; and which depend for their security and payment entirely upon the revenues derived from the properties against which they are issued.

Revenue Bonds, in the form in which they are known to-day, were first issued shortly before the beginning of the present century and have come into prominence only during the past 10 or 15 years. As a class, they occupy a recognized and respected position

*It should be made clear that our present use of the term is intended to exclude any reference to "Revenue Bonds" in the sense of short term bonds, notes, special assessments, or warrants issued by municipalities in anticipation of general taxes or other ordinary public revenues. With such issues, the present chapter does not concern itself.

among municipal securities, and in a few instances, particularly in the case of bonds payable from water revenues, they have at times commanded better prices than general tax bonds of the same municipalities.

Recent History

THE varying volume in which Revenue Bonds have been issued in recent years has been more or less due to the changing trends to and from public ownership of public utility enterprises. In the five years ending with 1922, there was an increased tendency toward municipal operation. Between 1922 and 1927, on the contrary, the trend was strongly in the opposite direction—cities served by municipal plants decreased, while those supplied by commercial plants increased. This was the result of large scale production of electric power at low cost and the general high state of efficiency attained by the private companies. Throughout the period which followed, the trend away from municipal operation continued, and showed no signs of a reversal until comparatively recently.

Beginning in 1933 the Government, as a part of its recovery program, encouraged municipalities to borrow from Federal agencies for certain purposes, some of these funds being available for financing the construction of electric plants and other municipal utility enterprises. As a result, a new stimulus was given to the public ownership movement.

Most of the large cities of the United States have substantial amounts of bonds outstanding which were issued for municipal utility purposes. The most heavily indebted for this purpose among the leading cities are New York, Boston, Detroit, Los Angeles, and Seattle. Detroit and Seattle have probably gone farther in proportion to their size than any of the rest. By no means all of this utility debt, of course, takes the form of Revenue Bonds. For example, the great rapid transit (subway) debt of New York City, also its water debt, consists of general obligations. On the other hand, the water bonds of Chicago (except for a few issued many years ago) and of St. Louis, and the street railway, water, and light and power bonds of Seattle are payable solely from revenues, and not from general taxes.

Various states have in comparatively recent years embarked

upon public undertakings financed not through Revenue Bonds as strictly defined, but through general obligations payable primarily from revenues or taxes levied for the services rendered by state agencies, or privileges afforded by state developmental projects. For example, Arkansas paid for an extensive highway building program through the sale of State bonds for which service is provided from gasoline and vehicle license taxes. Similarly, the Louisiana Port Commission, an agency of the State of Louisiana, has sold various issues for the development of the Port of New Orleans which are payable primarily from port charges. In the last analysis both are construed to be general obligations of the issuing states.

One purpose which usually underlies the issuance of Revenue Bonds is to provide additional facilities or revenues for a community without increasing taxes or exceeding constitutional or statutory debt limits. Since Revenue Bonds are intended to be wholly self-supporting they should not add anything to the ad valorem tax burden of the municipality, and are for this reason usually eliminated in calculating the net indebtedness of the community.

An Interesting Issue

AN interesting issue of Revenue Bonds is the City of Indianapolis, Ind., Gas Plant Revenue Bonds, maturing serially June 1, 1938 to 1967 inclusive. The circular describing this issue recites, among other things:

"These bonds constitute, in the opinion of counsel, valid and binding obligations of the City of Indianapolis, Indiana, in accordance with the terms and provisions thereof, secured by a charge upon all of the income and revenues of all the gas utility system now or hereafter owned and/or operated by said City and payable solely and exclusively out of such income and revenues.

"Under said resolution adopted May 7, 1935 the City covenants to fix, maintain and collect reasonable and just charges for gas service and faithfully to comply with all pertinent provisions of law including the requirement of Chapter 190 of the Acts of 1933 General Assembly of the State of Indiana, viz., that a reasonable and just charge shall be such as produces sufficient revenue to pay, among other things, principal of and interest on these bonds,

maintenance cost, operating charges, adequate funds for working capital, repairs and upkeep."

Points to Consider

IN ISSUING Revenue Bonds, as the foregoing statement indicates, the borrowing community covenants with the bondholder to maintain rates for utility service intended at all times to be sufficient to meet charges upon the bonds. It must be apparent to anyone who has followed the discussion to this point that, although Revenue Bonds are not protected by the full faith and credit of the issuing municipality, the covenant to maintain adequate rates is a most important element in their security. The value of this covenant depends upon the financial strength and the character of the community making it. Thus the prospective purchaser of securities of this type should consider the present position of the community and its debt history as well as all questions connected with its administration, industrial stability, and other elements which contribute to its soundness and responsibility. He should review the same group of factors, in short, which he would scrutinize in selecting general tax obligations.

Having satisfied himself on these points, the investor should turn his attention next to consider the enterprise for which the bonds are to be issued. It is essential, first of all, that the community afford a satisfactory market for the kind of service to be provided. A long established and industrially well diversified field of operation is obviously much to be preferred to one which is either unstable or showing distinctly downgrade characteristics. The situation from the standpoint of competition, present or prospective, should be considered. In cases where a private system is being acquired by a municipality, the earnings should have been adequate, after allowance has been made for financial changes incident to the transfer from private to public ownership, to pay all service requirements on the bonds, as well as all operating and other expenses.

The circular used in offering the City of Indianapolis, Indiana, Gas Plant Revenue 4½s from which a quotation has already been presented, states the following in regard to earnings:

"The following comparative earning statement, based on municipal ownership and operation, of Citizens Gas Company was

compiled from the independent engineer's report submitted us June 22, 1935:

	1931	1932	1933	1934	1935*
Total Income	$5,049,486	$4,326,724	$4,148,698	$4,773,273	$5,103,650
Operating Expenses, Taxes and Rentals	4,224,566	3,731,900	3,628,957	4,104,460	4,351,400
Balance	$ 824,920	$ 594,824	$ 519,741	$ 668,813	$ 752,250
Add: Estimated savings in taxes through municipal ownership and operation (see note)	$ 163,664	$ 142,516	$ 122,733	$ 113,811	$ 121,000
Balance available for bond service and depreciation	$ 988,584	$ 737,340	$ 642,474	$ 782,624	$ 873,250

The annual service charge on this issue is $360,000 1936-1937; $450,000 1938-1940; $500,000 1941-1967. *1935—5 months actual, 7 months estimated.

(Note)—The City states that through municipal ownership and operation of Citizens Gas Company there will be a savings of Federal Income and City taxes which in the years covered above would have approximated the amounts shown."

The prospective purchaser of Revenue Bonds should satisfy himself that the covenants which will protect his securities will not only insure the collection of rates for service which are sufficient to cover interest on the bonds and all expenses, but will offset depreciation and maintenance of the properties and provide for the retirement of the bonds.

Another point which should be investigated with special care where bonds are payable solely from utility revenues is the ratio of property value of the utility to the amount of debt to be outstanding. If a municipal utility property is bonded conservatively, the investor can properly feel a greater degree of security than that to which he would be entitled if there were serious question whether the property could be sold for the amount of the debt. Although the primary security resides in the covenant to maintain adequate rates, there is always the possibility that the municipality may become weary of its utility enterprise at some time in the future and wish to turn it back to private ownership. If that happens, it is obviously desirable that the property have a sale value comparing favorably with the bonds outstanding. The fact must be recognized, however, that when private properties are acquired for municipal operation, and paid for through the issuance of Revenue Bonds, the bond issue may approximate the full acquisition price, no equity money ordinarily being available as in the case of private corporations.

Emphasis should again be placed at this point upon the impor-

tance of proper bookkeeping on the results of municipal utility operation. Dishonesty has probably had less to do with the failure of municipal enterprises than most people suppose, but this does not alter the fact that opportunity for mismanagement and extravagance are open unless the local officials are held to strict account. Management which is subject to the necessities of politics is usually under pressure to make a good showing, and restrictions on accounting practice are therefore desirable.

Legal Status

ALTHOUGH Revenue Bonds, when self-supporting, are deducted from the gross debt of the municipality, they are none the less obligations of the issuing community. The validity of the statutes upon which the legal security of Revenue Bonds is based has been tested and found constitutional by the highest courts in numerous states. Thus, the position of the investor holding such obligations has been clearly established.

Price and Marketability

GENERALLY speaking, Revenue Bonds command prices slightly less favorable than the general tax bonds of the same community—although this is by no means true under all conditions. Also, Revenue Bonds are usually not as readily marketable as general obligations, since the secondary market for the former is frequently confined to the house of origination, and is therefore more restricted. In most cases, too, revenue issues are outstanding in smaller volume than the general tax issues, and hence are traded less actively. Because Revenue Bonds are purchased for permanent investment possibly to an even greater extent than general tax bonds, their lesser marketability or activity, where present, may be unimportant to purchasers, and is usually compensated for in more attractive yields.

Tax Exemption

ALTHOUGH, as has already been pointed out, the issuance of Revenue Bonds does not affect the power of a municipality to incur indebtedness within constitutional or statutory debt

limits, they are, nevertheless, municipal obligations, and the interest derived from them is generally regarded as exempt from present Federal income taxes. This, of course, is another important factor in their desirability for investment.

Record

WHILE Revenue Bonds are a comparatively modern development, they have established an excellent record for prompt payment of interest and principal throughout their history. It is especially worthy of note that this type of obligation demonstrated very gratifying strength during the depression years. In several instances, the Revenue Bonds of a municipality continued to pay their interest promptly and regularly at the same time that general obligations of the community were in default because of the inability of the authorities to collect property taxes in amounts sufficient to meet principal and interest and other civic expenses.

This brings out very strikingly an important factor affecting the collection of the two types of revenue—ordinarily, general taxes are collected annually or semi-annually; water and other utility bills are usually collected more frequently, generally monthly or quarterly. Property taxes may often be long delinquent before the taxpayer fears that drastic action will be taken against him; utility bills, on the other hand, can usually not be allowed to run behind more than a few months at the most without the certainty that service will be shut off. Water is so vitally necessary, and electricity and gas have become so essential to present day life, that few users fail to bestir themselves sufficiently to pay the charges necessary to keep service uninterrupted.

Present-Day Status of Tax-Exemption in Municipal Bonds

AT INTERVALS over many years there has been renewed agitation, in and out of Congress, for the abolition of the tax-exemption privileges of state and municipal bonds and of the bonds of the Federal Government. Naturally enough, the subject generally receives most attention in times of financial difficulty, when ways are being considered for increasing revenues or reducing the tax strain in other directions; and it is therefore not surprising that the matter has been much discussed during recent years.

To understand the status of state and local municipal issues from the standpoint of their freedom from Federal Income taxes, it is helpful to consider the historical aspects of such immunity.

Basis for Exemption

THE Constitution of the United States, as it stands today, says nothing directly regarding the power of the Federal Government to tax the principal or interest of state or municipal

bonds. The tax-free position of such bonds depends rather upon what is implied in the Constitution and in the American theory of dual sovereignty.

When the Constitution was framed, certain sovereign powers were conferred upon the Federal Government by the states. All the other powers of sovereignty not expressly given the Federal Government were retained by the states.

Originally, the Federal Government was prohibited from imposing direct taxes, unless these were levied in proportion to the census. The power of taxation for state and local purposes was reserved to themselves by the states. Conflicts between the Federal and the state governments eventually arose. In a famous early case, Chief Justice Marshall declared that the states had no power, by taxation or otherwise, to impede, burden, or in any manner control the operation of the law enacted by Congress to carry into effect the powers vested in the Federal Government. He pointed out that if the states were assumed to have the powers to tax the Federal Government, or any of the means or instrumentalities through which it exercises the powers given it by the Constitution, the Federal Government would be subordinate to the states. Supporting this view, a later decision declared that if a municipality were permitted to tax the obligations of the United States Government, the tax would be a tax upon the borrower, and therefore a restraint upon the exercise of the power of the Federal Government to borrow money. The position taken by the Supreme Court was that to permit a state or one of its subdivisions to tax a Federal obligation was inconsistent with the system of dual sovereignty—for which the Constitution provides.

In harmony with this doctrine, the courts also held that the Federal Government can not tax the governmental functions of states—levy a tax, in other words, upon the income from bonds issued by state governments or their subdivisions.

The Federal Government did not find practical means to levy income taxes until the Sixteenth Amendment to the Constitution was ratified. This Amendment gave Congress power to "lay and collect taxes on incomes from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

This Amendment was thought to open the way for taxing the income from state and municipal bonds. The United States

Supreme Court decided that the Amendment "does not extend the taxing power to new or excepted subjects."

It thus became established doctrine that the United States may not tax state or municipal obligations, and this principle has been recognized repeatedly in both Federal and State courts.

The judicial decisions which have been referred to in the foregoing discussion have concerned the *income* derived from state and municipal securities.

Indirect Taxation of Exempt Issues

IT should perhaps be recognized here that, notwithstanding the consistent attitude of the courts on the matter of taxing such securities, means have been found for taxing them indirectly. State and municipal bonds (and the same is true of Government bonds) and the income derived from them are subject, for example, to inheritance taxes—which are taxes, not upon the securities, but upon the right to inherit. The amount of such taxes, moreover, may be determined by the value of the inheritance, even in cases where the property bequeathed consists wholly of tax-exempt securities.

Similarly, franchise taxes have been sustained by the courts. Here again the taxes are not upon the securities themselves, but upon the right to exercise the corporate franchise. The amount of such taxes may be determined by corporate income, including income from tax-exempt securities.

Constitutional Amendment Advocated

JUDGING from the repeated declarations by the courts, there seems to be very little chance that tax-exempt bonds will be made taxable as to income while the Federal Constitution remains what it is today. Apparently, the way to alter the tax status of such bonds would be through an amendment to the Constitution.

The Secretary of the Treasury is reported to have appeared before the house judiciary committee on March 8, 1934, and recommended that a constitutional amendment be drawn to permit the taxation of the income from state and municipal securities. He advocated a reciprocal arrangement whereby the states would be permitted to tax the income from Federal securities, and the Federal Government to tax the income from state and municipal

securities. It was reported at the same time that several proposed Constitutional amendments were pending in the House and Senate, and there was known to be considerable congressional sentiment against tax exemption. It was admitted, however, that ratification of such an amendment by 36 states would be difficult to secure.

The reported attitude of the Treasury represented no radical departure from that which has long prevailed there. It was understood that a former Secretary of the Treasury opposed tax exemption on the ground that it encouraged states and cities to go too heavily into debt.

Revenue Aspects of Removal of Exemption

ON the 1934 occasion when the Secretary of the Treasury urged a constitutional amendment to permit the taxation of tax-exempt securities, a Treasury Department fiscal expert estimated before the committee that such action would provide $145,000,000 of additional revenues to the Federal Government annually. He did not, however, estimate the amounts which states and municipalities might derive from taxes upon Federal securities now tax-exempt. According to this expert, $11,500,000,000 of wholly tax-exempt Federal securities were outstanding at the end of 1933, while those exempt from normal tax, but subject to surtax, totaled $13,500,000,000. Recent estimates of state and municipal securities outstanding place the total around $20,000,000,000.

It goes without saying, of course, that the imposition of a tax upon securities now exempt, might not represent a net gain to the governments benefiting by the tax. According to reports published in the latter part of 1933, a memorandum furnished to the House Ways and Means Committee indicated that the maximum revenue that could be obtained by the Federal Government from the taxation of interest on all Federal, state and local bonds would not exceed $160,000,000. On the other hand, it was calculated that an increase of ¼ of 1% on $40,000,000,000 of then outstanding interest-bearing indebtedness of the Federal, state and local governments would amount to $100,000,000, and an increase of ½ of 1% would amount to $200,000,000.

These, of course, are merely estimates, supported by very little practical experience. Whether the cost of borrowing to the Federal,

state and local governments would be increased through removal of the exemption privilege by as much as ¼% or ½% is a question that can never be answered definitely unless and until exemption is actually abolished; and, even then, the measure of the value of exemption would almost certainly be confused to a greater or less extent by the many other factors which determine bond prices.

It might be thought that some actual data as to the practical value in the market place of tax exemption might be secured by a study of tax-exempt bond prices in relation to wide changes in Federal income tax rates. Such, however, is not the case. As was pointed out in the first chapter of this booklet, the enactment of the Federal Income Tax Law in 1913 resulted in no great change in the general level of municipal bond prices. Another fact of interest in this connection is that the years in which Federal income tax rates have reached extremely high levels have also been years when municipal bond prices have ordinarily been relatively low. Even the high prices which state and municipal bonds commanded in recent years are evidently not to be accounted for by higher income tax rates, for taxable issues of the best quality likewise rose to high levels.

Other Questions Involved

RETURNING to the question of a possible Constitutional amendment, a number of questions invite consideration.

First, would the taxation apply to bonds already outstanding, or only to future issues? That would depend upon the nature of the amendment. According to an authoritative opinion on the subject, there is nothing to prevent the amendment of the Constitution in such a way that Congress could tax outstanding as well as future issues of state and municipal bonds and the bonds themselves as well as the income from them.

Again, the question is asked sometimes whether such taxation would not constitute a breach of contract on the part of the Federal Government. So far as Federal taxation of state and municipal bonds is concerned, it is stated on good authority that there would be no violation of contract, for the simple reason that the Federal Government has made no contract with the holders of such bonds. The only contract which exists is between the issuing state or municipality and the holder, and in this the Federal Government has

no part. The Federal Government has made no agreement to exempt such bonds, and it has not taxed them in the past because it has not had the authority to do so

Another question sometimes asked is whether any bond—Federal, state, or municipal—can be sold as tax-exempt and later taxed by the issuing government.

Regardless of whether or not the exemption is a contract made by the Federal Government, a state or a municipality, by constitutional amendment it would be possible, according to eminent legal authority, to subject such securities to taxation. Their argument is that the only thing that prevents a state from levying a tax upon a bond, or the income derived therefrom, when it has contracted with the holder for an exemption from taxation, is the provision of the Federal Constitution inhibiting the state from violating the obligation of contract. If that section of the Constitution were repealed, there would be no impediment to such taxation, regardless of the contract, and for the same reason such taxes could be levied if the Federal Constitution were amended so as to authorize them. There is no clause of the Federal Constitution expressly prohibiting the Federal Government from violating the obligation of contract. The Fifth Amendment prohibits the United States from depriving a person of property without due process of law, and this amendment has been construed in certain cases as prohibiting the Federal Government from violating contracts which it has made, but if the people, by constitutional amendment, expressly confer upon the Federal Government the power to tax securities, regardless of the fact that it has previously contracted to exempt them from taxation, there would be nothing to prevent such levies.

All the power of government is vested in the people of the United States. They can amend the Constitution, in the manner provided in that instrument, in any way they see fit. If they choose to violate their contracts there is no higher tribunal to which an appeal can be taken from their decision. It appears improbable that the American people would deliberately repudiate such a contract, but it must be recognized that it is within their power to do so.

Whatever course pursued, it seems probable that a determined effort may be made within the next few years to bring all or part of the billions of bonds now exempt within reach of the tax gatherer. How successful these attempts may be remains to be seen.

Alternative Courses

AMONG other possibilities mentioned by authorities on the subject of tax exemption are these:

If the Supreme Court should become convinced that tax exemption constitutes a serious economic and political evil, the means might conceivably be found to depart from the doctrine which has hitherto held sway. It must be remembered in this connection that the Supreme Court was by no means unanimous in support of the opinions which prevailed in the matter of tax exemption, and altered conditions and substantial change in the views of the members of United States Supreme Court might result in a modification of the position which that body has maintained in the past.

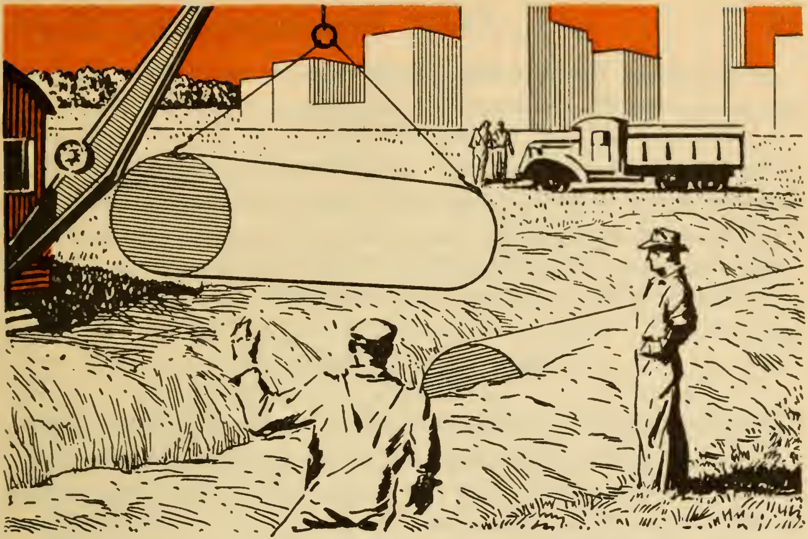
Another possibility is the type of reciprocal arrangement which a Secretary of the Treasury was recently reported to have recommended. This could take the form of a bargain between the Federal and state governments, a course which some authorities think the courts might sustain.

Another way to circumvent the legal difficulties might be to compute the tax upon the total income of the taxpayer from both taxable and non-taxable sources and then levy the tax upon taxable portions of his income at the higher resulting rates. It is believed by some that this procedure might be sustained by the courts.

It has also been suggested that bonds issued for certain purposes might be considered taxable on the ground that the purposes are not governmental. This course, however, would be open to many objections from the standpoint of public policy, since it would lay a burden upon certain activities which the borrowing state or local government would doubtless have considered desirable or necessary.

Another method which has been suggested for reaching of income now exempt from taxation would be to place higher taxes upon inheritances.

It may be that one or another of the suggested courses will eventually be adopted. The chance that something will be attempted in one of these directions or another are certainly better, according to leading authorities on the subject, than the possibility that the Supreme Court would directly reverse its former decisions.



Institutional Practice as a Guide to the Individual Purchaser of Municipal Bonds

OUT of the confusion and reverses of the depression came a natural determination on the part of many thousands of investors to revise their previous investment procedure. In seeking guidance for a new and revised program, obviously no better practice could be followed than to consider the policies of those individuals or institutions whose investment procedure carried them successfully through the turmoil of the distress period. Among these, two great institutional buyers stand out: the life insurance companies and the savings banks of the country. Despite the storm and stress since the year 1929, both types of institutions, with only minor exceptions, came through with relatively unimpaired strength. Considering their vast size, and the resulting opportunity for error, it is apparent that there was a soundness in their investment practice that the individual, genuinely interested in charting his own course wisely, may well examine.

At the outset, the individual buyer must recognize that his situation and his problems are essentially his own; that the investment practices and policies of only those individuals and institutions more or less identically situated with himself can be copied in their entirety. Even so, there is obviously much that can be adapted to his own usage in studying the investment methods of institutions which have so thoroughly demonstrated the soundness of their policies as have the two types here referred to.

Governing Policies

THE policy that stands out first in any consideration of these two great institutional buyers is that they are investors in the real sense of the word. They are concerned first and always with security of principal, they exercise moderation in their yield requirements, and they are interested—if at all—only incidentally in speculative profits. Some of their conservatism is admittedly imposed upon them by state laws, which seek to provide maximum protection to depositors or beneficiaries. Such state laws, in some cases, limit their selections to carefully restricted fields. However, even when the laws permit of wide latitude, the long experience of these institutions has demonstrated the wisdom of ultra-conservatism in the choice of their investments.

Diversification

A SECOND significant policy immediately evident in studying the procedure of the most successful institutional buyers is their recognition that there is risk in all investments. To safeguard themselves against this risk, they not only endeavor to confine themselves to those investments where the risk is reduced to a minimum but they add the further protection of diversification. They diversify by types of investments, and among the various classifications of bonds; they diversify by maturity, by industries, geographically and, to some extent, by degree of marketability. They limit their unit of investment in any single enterprise or community to a reasonable percentage of their total assets. They do not make the mistake of regarding diversification as a substitute for careful selection of individual issues but regard it as a reinforcement of the whole structure of well chosen components.

Supervision

NOR are these astute investors content to choose carefully and to distribute their risk through diversification; they recognize that all investments require supervision; that, though sound at the time of purchase, their status may change with shifts in management, in general business conditions, or conditions within a particular community or investment classification. Accordingly, these investors review their holdings periodically and suit their actions to the findings of their investigations. In this connection, it is important to note that values, as disclosed by their studies, govern their actions rather than over-reliance on market quotations which may or may not reflect true values. By this is meant that they recognize that merely because a bond is quoted at a discount is not necessarily a reason for disposing of it. Neither does it follow that the profit should be taken because an investment is selling well above its purchase price. Income and protection of principal, not profits, are the goals towards which they are constantly striving.

Consistent Buying

ONE other practice of the institutional buyer, particularly significant to the individual investor, is their almost continuous buying. As a general rule these buyers are not deterred from action because prices are high or low; they recognize the futility of trying to guess the top or the bottom of security price movements and content themselves with getting an average of such movements through steady employment of funds as they become available. It is true, of course, that they adapt their buying to prevailing conditions, favoring short-term securities at certain times, long-term at others. It is also true that they discriminate among investment fields as conditions change. At certain periods, farm or city mortgages have been favored; at others, railroad bonds; again, public utility bonds have had preference. In recent years, municipal bonds, long a favored investment among insurance companies, have come to occupy an even more important place in the buying of these discriminating buyers. All this stresses the fact that such buyers, rather than pursuing a do-nothing policy during periods of transition, go ahead courageously and seek to obtain the best of the offerings available in the market at the time.

Municipals Favored

TO THE buyer who has favored municipal bonds, or who may be considering them for the first time, there is significance in the recent substantial increase in the purchases of such bonds by institutional buyers. Between 1929 and 1936, according to statements of the Comptroller of the Currency, reporting mutual savings banks increased their holdings of domestic, state and municipal bonds from $509,382,000 in 1929 to $798,699,000 in 1936. The recent increase in holdings of municipal bonds by insurance companies is particularly interesting. Between 1906 and 1936, the percentage of municipal bonds to total assets ranged from 3.6% to 5.7% among forty-nine legal reserve companies having, at the latter date, about 92% of the total assets of all such companies. Expressed in amounts rather than ratios, the total domestic, state and municipal obligations of the forty-nine companies rose from $103,789,000 in 1906 to $1,299,000,000 (estimated) at the end of December, 1936. The recent purchases of such bonds for 44 leading companies as reported in an authoritative financial publication were about 300 millions in 1935, and $225,000,000 in 1936.

Granting that some part of the recent large increase in municipal holdings on the part of these experienced buyers resulted from scarcity of other desirable new investments in the volume required, the trend, nevertheless, has significance for the individual buyer attempting to chart his own present and future course.

Insurance Company Investments

EVEN though it is questionable how far the individual buyer of municipal bonds should attempt to copy the exact buying standards of the institutional investor, it is, nevertheless, a matter of interest to know something about just what these standards are. These can be indicated best by a summary of the laws governing the investments in municipal bonds by savings banks and life insurance companies in a few of the eastern states, in which are located some of the largest institutions of these two types.

The type and character of municipal obligations which can be purchased by insurance companies in Connecticut and New York are in the main not subject to restrictive legal definition. The

Connecticut Law contains no provision restricting the purchase of municipal bonds by insurance companies and under the New York Law, authorized bonds or evidences of debt of any state, or of any city, county, town, village, school district, municipality or other civil division of any state may be acquired for investment.

Under the Massachusetts Law, investments may be made without restriction in the public funds of any state and in the legally authorized bonds or notes of any county, city, town, school or water district in Massachusetts. As regards bonds and notes of any political subdivision of any other state, the law requires that they be direct obligations of such political subdivisions, and that if the population is less than 100,000, then the indebtedness in each case, after deducting water debt and sinking funds, shall not be in excess of 5% of the assessed valuation of the property for tax purposes.

Savings Bank Investments

THE Savings Bank Laws of these states, however, define much more specifically the various types of municipal obligations which are legal investments. In New York and Massachusetts they are divided into four groups, namely: (1) state obligations, (2) obligations of municipalities within the state, (3) obligations of municipalities located in adjoining or nearby states and (4) municipalities of other states. Connecticut has only three groups since it combines the last two mentioned above. The standards of eligibility under each group are different and vary as between states. The standards relative to obligations of municipalities within each of the three states are more liberal than for municipalities in other states. Some of these differences in standards follow.

Bases of Qualification

EACH of the three states makes eligible to savings banks the obligations of a number of different types of its own municipalities such as counties, cities, towns and various districts. Distinct limitations, however, exist in the types of municipalities of other states whose obligations are eligible. New York, for instance, admits only the obligations of certain cities, school districts, or counties coterminous with or including such cities if located in states other than those adjoining New York. Massachusetts and

Connecticut admit only the bonds of certain cities in other states.

All three of the states require that such cities shall have been incorporated not less than twenty-five years.

Population Requirements

FOR municipalities located within the state, no limits as to population are set up by any of the three states. For municipalities in adjoining states, New York sets a minimum of 10,000 population, while Massachusetts has no requirement for any of the New England States except that of a population of 5,000 for water districts. For cities in other states, New York and Massachusetts set 30,000 population as the minimum and Connecticut establishes a minimum of 20,000 for all cities outside the state.

Debt Limits

MUNICIPALITIES in New York, Connecticut and Massachusetts are subject to legal restriction in the incurring of debt. In the Savings Bank Laws, therefore, no restrictions regarding debt limitations are placed on municipalities within those states except in the case of the Massachusetts Law which limits the debt of incorporated districts to 5% of the assessed value of property for tax purposes. For municipalities outside the state, however, definite restrictions governing debt limits are set up. New York sets a limit of 12% for cities and 5% for counties, with an additional 3% allowed cities not in a county. This limit is not applicable, however, to cities with a population of 150,000 and over, having an assessed valuation of real property in excess of $200,000,000, if power to tax is without limitation as to rate or amount.

Under the Massachusetts Law, the debt limit for New England cities is 5% and 3% for counties, towns and water districts. The limit for cities in other states is 5% with a limit of 7% permitted cities of more than 100,000 population.

Connecticut has a debt limit of 7% for all cities outside the state.

Defaults

NO PROVISIONS regarding defaults are incorporated in the Savings Bank Laws of any of the three states relative to obligations of municipalities within the state. But in other classifi-

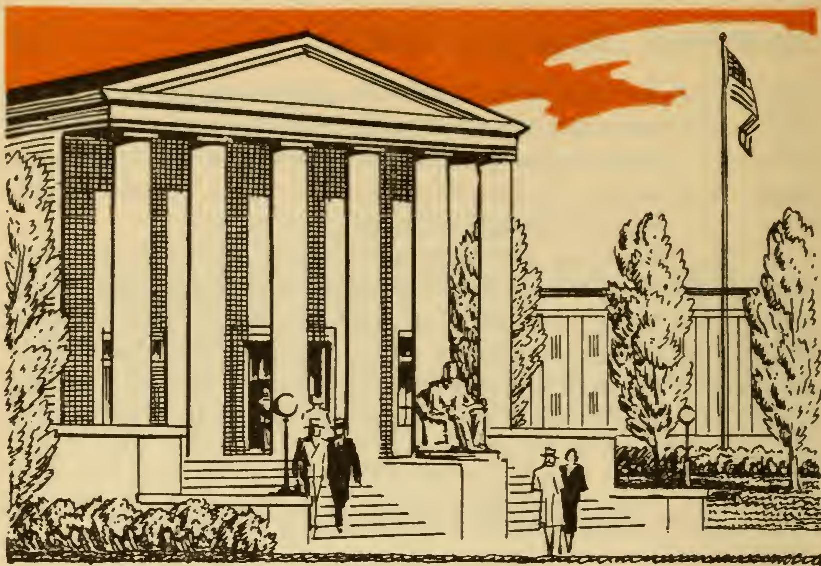
cations, definite restrictions exist. On obligations of other states, New York and Connecticut provide that there shall not have been any default for more than 90 days within ten years preceding investment. Massachusetts does not allow for any default within 20 years preceding investment.

On the obligations of cities of other states, New York requires that no default shall have occurred for more than 120 days within 25 years preceding investment, and Massachusetts, 120 days within 10 years preceding investment. Connecticut requires that neither the city nor the state in which such city is located, shall have defaulted for more than 90 days within 15 years preceding investment.

Payable from Unlimited Taxation

THE New York Savings Bank Law provides that obligations of any city of less than 45,000 population or school district or county in states other than those adjoining New York must be payable from unlimited taxation.

The New York Law also contains a provision that after 1938, no obligation issued by any city, county, school district or other municipality shall be an authorized investment unless such city, county, school district, or municipality shall have power to levy taxes on the taxable real property therein for the payment of such obligations without limitation of rate or amount.



Secondary Factors Influencing Prices of Municipal Bonds

IN PREVIOUS chapters the major factors which determine the market prices of municipal bonds have been outlined. Briefly, these factors are: (1) the intrinsic soundness of the individual issue; (2) the supply of and demand for investments of its particular type; (3) prevailing money rates; (4) tax exemption.

In addition to these primary factors controlling the prices of municipal bonds there are numerous secondary factors, which, while not the more important determinants, nevertheless do influence prices. These secondary factors are often not individually important but, collectively, they merit consideration by careful investors seeking to obtain maximum values in the choice of their investments. Among the most important of these are certain incidental characteristics of the municipal bond itself, such as:

Coupon Rate

MANY investors dislike to pay a high premium for bonds. High coupon bonds issued during a period of high money rates, may sell at so great a premium during periods of low money rates as to materially limit the demand for them. At a time when most municipal bonds command premiums, the occasional offerings of low coupon bonds at a discount may enjoy a greater degree of marketability and consequently command lower basis prices than comparable bonds having high coupon rates.

Institutions and certain other large purchasers customarily amortize over the life of their bonds any premiums paid at time of purchase. If such procedure is followed, an advantage may be derived through purchases at a greater yield basis due to the less desirable market position of the high premium bonds. As was previously pointed out, in the case of a bond having a very short maturity, varying coupon rates do not result in important differences in dollar prices at the same yield basis, and consequently the significance of premiums and discounts as price determinants is ordinarily negligible among the shorter term obligations. Thus, the coupon rate of a bond has a bearing on its market price, particularly in so far as the longer maturities are concerned.

Maturity

WHETHER the prevailing investment demand is for long or short maturities is reflected to some extent in the market price of all bonds, including municipals. Ordinarily, during periods of high money, investors seek to lengthen the advantage of such rates by buying long-term bonds. Vice versa, during periods of low money rates, they prefer short-term securities anticipating or hoping that, at maturity, they may reinvest to better advantage. If, therefore, the holder of a short-term municipal security wishes to sell when the prevailing demand is for longer term issues, he may be at a slight disadvantage; contrariwise, long-term issues might be at a disadvantage during a time when purchasers, generally, are favoring short-term issues. Thus, generally speaking, the maturity of a bond may have considerable bearing on its selling price.

Callable Features

MOST municipal bonds are issued in serial form—a portion of the issue falling due annually, or semi-annually over a period of years. Usually, such bonds are not callable prior to maturity. Occasionally, however, it is provided that such bonds may be called on or after a specified date or dates, or at any time after specified public notice. Under some circumstances, it might obviously be a disadvantage to the investor to have his bonds called for payment prior to maturity. Thus a call feature introduces an element of uncertainty as to the life of the bond, which may affect adversely the market price of the issue.

The yield of optional bonds selling at a discount is customarily figured to the full maturity date so that the optional feature does not materially affect market value. The yield of optional bonds selling at a premium, however, is most frequently figured to the first optional date and consequently the redemption provision is decidedly important. Exceptions to the latter manner of computation may be found in the infrequent case of bonds callable at premiums sufficient to offset the effect of the possible shorter life due to the redemption provision.

Title or Purpose of the Bond

SOME difference in demand may exist among bonds of the same community but bearing different titles or issued for different purposes. Assuming that all such issues are direct and general obligations and payable from ad valorem taxes, without limit as to rate or amount, any such preference is without justification in so far as legal status is concerned. The fact remains, nevertheless, that it assumes importance in the minds of some investors and, that being true, has some effect marketwise on such bonds. Such prejudices against certain purposes may only be justified on the theoretical grounds that, if difficulties in payment of its obligations are encountered by a municipality, public opinion and financial expediency may react to the detriment of those bonds issued for purposes regarded as least desirable. However, assuming "ability to pay" is unquestioned and the bonds are the same from the standpoint of legality and manner of payment, the enforce-

ability of the contract is not hampered because of any question regarding the propriety of the financing.

Denomination

MUNICIPAL bonds are usually issued in units of $1,000. Prices are quoted on the assumption that the bonds are in denomination of $1,000. Occasionally, the total amount of an issue may be determined by the exact cost of the improvements for which the bonds are issued resulting in one or more odd denomination bonds. Again, the bonds may be issued purposely in amounts of $100 and $500. Such smaller amounts, more particularly the odd denomination bonds, have a more limited market and therefore may be priced at slightly different levels than the standard $1,000 pieces. Similarly, bonds of denomination greater than $1,000 have a market restricted to those buyers capable and desirous of purchasing the larger amounts.

Interest Payment Dates

INTEREST on municipal bonds, as in the case of bonds generally, is usually payable semi-annually. Investors are accustomed to expect payment at such intervals and where, as is occasionally the case, coupons are paid annually, or where the first or last coupons of an issue may be for an odd period, some market resistance may result though obviously it would be slight.

Place of Payment

IT IS generally preferred that principal and interest of municipal bonds be payable in Chicago, New York City or some other metropolitan center. This is because of the greater convenience to the buyer of the bonds in collecting his payments when due. Often, however, it is provided that payment shall be made in the issuing community. If the community happens to be a small place removed from the financial centers, that fact, even though unimportant in itself, may adversely influence some buyers and, by such reduction in demand, correspondingly affect the market price of the issue.

Registration

WHETHER an issue is registrable as to principal and/or interest is unimportant to the great majority of buyers. To a few, however, it may be important. Most municipal issues are registrable, but where that feature is absent, and yet desired by even a few buyers, its absence may stand in the way of purchase on the part of such buyers and limit to that extent the demand for it. Lack of registrability, however, is not of sufficient importance to affect appreciably the market price of the issue.

Municipal bonds once registered as to principal and interest are ordinarily not exchangeable into coupon form and, since such registered bonds are not desired by the majority of purchasers, their marketability is impaired and they usually yield more than comparable offerings in coupon form.

Other Influencing Factors

IN addition to these secondary qualities inherent in the bond itself, the presence or absence of which may be important to the minority of investors and, therefore, reflected to some extent in the current market of the bonds in question, certain other factors of varying importance may also have an effect on the price level of a given issue of municipal bonds. Some of these are briefly dealt with in the following pages.

"Odd Lots"

MUNICIPAL bonds are ordinarily dealt in in amounts of $5000 or more. Except as a part of a larger offering, where prices are uniform regardless of amount, purchases or sales of less than $5000 may have to be made at slightly different price levels than in larger amounts. These so-called "odd lot" transactions may involve effort on the part of the dealer out of proportion to the amount of the transaction which means that, in buying or selling, less favorable prices may be encountered by the investor. On the other hand, a dealer having a small amount of bonds left as a part of an original offering of larger amount may sometimes price it at an attractive figure to close out the issue.

Legal Opinion

THE importance of the opinion approving legality of a given issue has previously been stressed. A legal opinion is a prerequisite to good delivery of municipal bonds and, whether the opinion is rendered by a widely known firm of lawyers, or by a less recognized firm, quite naturally influences discriminating buyers. Thus, the market price of the issue may be influenced by the nature of the legal opinion.

Eligibility for Certain Purposes

ELIGIBILITY of certain municipal bonds for the investments of savings banks, insurance companies, postal savings, etc., is, of course, a reflection of their desirability as measured by the standards governing their acceptability for these purposes. Except as an indication of their presumed high quality, such eligibility has no particular value to the private investor. In buying such bonds, he is competing in the market with those for whom this quality has real value. This applies to some extent also to bonds acceptable to secure public deposits; to those suitable for certain large pension funds, for municipal sinking funds, etc. Obviously, however, it does not follow that such bonds should be ruled out of consideration merely because these particular characteristics are not required by the particular buyer.

Local Preferences or Prejudices

WHOLLY aside from intrinsic merit or local tax advantages, local preferences and prejudices may influence the price of an issue to some extent. A strong local demand may reflect merely local pride, or familiarity with the issue, on the part of investors within the community, leading them to prefer their own bonds to outside securities which they do not know so well. On the other hand, local political differences and disaffections may prejudice local investors against their own securities to a point where they underestimate their worth and an advantage is offered to the outsider who can look at the situation realistically, uninfluenced by local partisanship.

Oversupply and Scarcity Value

A GIVEN community, for good reason, may have been in the market rather continuously for funds, with the result that the major customary buyers may have taken all of its bonds that they care to purchase for the time being. Despite the admitted soundness of its offerings, and wholly aside from the question of general demand and supply for bonds of that type, the bonds of this particular community may lag marketwise. On the other hand, if no bonds, or an inadequate supply of bonds of a well regarded community, have appeared in the market over a considerable period, an accumulated demand for the bonds of that community may have developed to a point where, when a new offering appears, it will sell slightly higher than comparable bonds which have been available in more normal supply.

Dealer Strength

THE policy, financial responsibility, and distributive ability of the municipal bond dealer also influences in varying degrees the offering prices of bonds underwritten. Some dealers make a practice of specializing in certain types of bonds and their association with an offering tends to improve the market position of such an issue. Dealers having inadequate financial backing are sometimes obliged to liquidate holdings under adverse circumstances which necessitate sale of bonds at sacrifice prices and tend to depress the previously prevailing price level. Furthermore, in the case of some issues of the type not generally traded in the market as a whole, the unwillingness or inability of the originating house to maintain a satisfactory "secondary" market may result in a price level lower than the intrinsic value of the security justifies.

The market price of any bond, municipal or otherwise, is finally determined by a summing up and weighing of its individual qualities, good and bad. Every good quality has value, but often more so to one buyer than to another. The investor who pays for a factor of no importance to him is, in effect, bidding against another buyer to whom it is important. The investor who foregoes certain needed qualities for the benefit of a slight advantage in price is striking a doubtful bargain.